INDEPENDENT CONTRACTOR STATUS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

WASHINGTON, DC, JANUARY 19, 1995

Printed for the use of the Committee on Small Business

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INDEPENDENT CONTRACTOR STATUS

THURSDAY, JANUARY 19, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 2 p.m., in room 2359–A, Rayburn House Office Building, Hon. Jan Meyers (chairwoman of the committee) presiding.

Chairwoman MEYERS. I wonder if I could ask those on the first panel if they would take their places at the table. That would be Craig Willett, James Parmelee, Claudia Hill, Marc Wagner, and Cheryl Bass.

Our hearing this afternoon is the third in our series devoted to tax policy and small business. During this session we will focus on problems associated with the classification of workers as independent contractors by the Internal Revenue Service. The tax consequences for worker classification are of paramount importance to business owners and workers alike and in some instances can have stifling effects on the growth of small businesses. Where the defining lines of such classifications grow dim, small business owners often find themselves at significant financial risk, if not jeopardy, when, as in the past, the Internal Revenue Service seeks to reclassify many bona fide independent contractors as employees. By doing so, the IRS can often assess small business owners for back withholding taxes for each employee misclassified even when that employee has already paid self-employment and income taxes. In some cases the IRS also can add large penalties to those back taxes.

In response to the intensity with which the IRS had pursued independent contractor audits, Congress dealt with the independent contractor issue in 1978 and again in the early eighties. Both times, Congress found the independent contractor issue extremely divisive and complicated. The most difficult problem with independent contractor status remains the lack of a clear definition.

While the law passed in 1978 provided businesses with some safe harbors for determining who was an independent contractor, this area remains flawed. For example, the IRS has applied no less than 20 common law guidelines dating from 1935 to determine employment classification. Moreover, these factors have often been applied subjectively and inconsistently in the field. The IRS and the small business community have a mutual interest in clarifying this issue. As with all tax policies affecting small business, the IRS should be encouraged to adopt consistent and reasonable standards in classifying workers.

Our hearing this afternoon will look at a broad range of views on how best to classify workers, and I would at this time ask Mr. LaFalce if he has remarks to make.

[Chairwomen Meyers' statement may be found in the appendix.]

Mr. LAFALCE. I thank the gentlelady.

Our committee has traditionally been very concerned about the issue, the status of independent contractors, and has addressed the issue in numerous hearings, most recently in the context of health care reform last August.

In my view, it is essential that Congress act to end the conflict and confusion which arise from current law. In fact, we need a solution now more than ever as the number of self-employed continues to grow and proposals such as the health care tax deduction make the consequences of being an independent contractor even more significant.

At the Small Business Committee hearing in August, witnesses from the small business community emphasized that standards determining independent contractor status continue to be the source of significant conflict between Treasury and small businesses. However, the administration's proposal to authorize the Secretary of the Treasury to issue prospective clarifying regulations did not meet with much favor. Given legitimate concerns, the Treasury has been inclined to restrain the use of independent contractor status. Rather, the consensus seemed to be that Congress should attempt to reconcile divergent viewpoints and craft a legislative solution to the problem. I therefore welcome the opportunity to revisit this issue and to explore further some concrete proposals.

I do, however, regret that Treasury representatives are not here to testify today in the interest of having a complete discussion of views. A Treasury representative could shed light on the activities of the department in this area and on the fiscal consequences of both the present system and the alternative proposed changes.

Having said that, I look forward to the testimony of our witnesses who should provide us with diverse but equally important insights as to how the current law and proposed changes impact at least on the businesses they represent.

Thank you.

Chairwoman MEYERS. Thank you, Mr. LaFalce, and I will say that we do intend to have further hearings on this issue but today we wanted to hear the impact on small business.

Mr. Mfume.

Mr. MFUME. Madam Chairman, consistent with the rules adopted by the committee, I have an opening statement that I would ask unanimous consent be adopted and made part of the formal record.

Chairwoman MEYERS. Without objection.

[Mr. Mfume's statement may be found in the appendix.]

Chairwoman MEYERS. Are there others that would like to submit an opening statement?

[Mr. Lantos' statement may be found in the appendix.]

[Mr. Shays' statement may be found in the appendix.]

Chairwoman MEYERS. Our first witness will be Craig Willett. He is with Willett and Associates of Provo, Utah, and Mr. Willett will be speaking for himself of course and for NFIB.

TESTIMONY OF CRAIG WILLETT, WILLETT AND ASSOCIATES, PROVO, UTAH

Mr. WILLETT. Thank you, Madam Chairman. I would like to thank you for the opportunity to testify before you today. I have submitted a written testimony and would like it included as part of the record.

I am here to represent my views as a small business owner as well as those of NFIB. Some of the recommendations in the submitted testimony are derived from recommendations of a Washington coalition on independent contractors, and these recommendations are 2 years old and are currently being reconsidered. I would be happy to entertain questions on some of the specific recommendations that are made in the testimony. What I would like to do for my time today is share some real world examples of employee classification problems.

In my opinion, the Treasury Department is out of control. They claim that employers gain with the system. In my opinion, businesses are at a natural opposing view to the Internal Revenue Service, and that is due to the inherent nature of their objectives. Employers and the Treasury Department have different objectives, however well intentioned they may be. The Treasury Department's obligation is to collect as much revenue as possible. In 97 percent of their examinations of employer classifications they reclassify independent contractors as employees. I find it hard to believe that employers are out there abusing the system to the tune of 97 percent of the time. I don't think that employers are gaming with the system. However, there are some people who may be abusing the system.

I think the 97 percent reclassification rate that Treasury Department comes up with indicates an agenda that we are not all quite aware of as business owners. The solution to the problem lies in understanding each other's goals.

In addition to the fact that they reclassify 97 percent, I would say that there is an attitude problem in the Treasury Department. They indicate that 80 percent of the people comply in reporting the income who are independent contractors from their audit tests. They say that those people who had their income reported to the Treasury on form 1099 report 94 percent of their income, at least 94 percent of their income.

The problem is—and let me tell you an example. I had a client who was examined under one of these audits. As a CPA, I represented him, and the auditor came in and he said, "Let me explain to you. I'm going to go down this 20 point common law test, and I want to tell you that I might find in favor on 19 points for your clients but 1 of those 20 points I may find in favor of the Treasury Department, Internal Revenue Service, and if that point is overriding then I will have the subjective opinion to classify them as an employee." That was the exact result, and I would say that the instructions I believe that aren't known to the public are that the examiners are trained to reclassify and let it be resolved in appeals.

This is a particular burden to small business. Small business owners can't afford to appeal this type of an audit. It is extremely costly, can cost from $4,000 to $5,000 for just one employee under

an audit. We are not large businesses, we can't afford to go out and have a lot of brokers that we are trying to represent and do a large class action lawsuit, and therefore we have a real problem with this.

I also have an associate, a CPA, who had some of his clients audited and the IRS got their cake and ate it too. They got the taxes from the employer, as well as the independent contractors had filed tax returns and already paid the tax and got no credit for that. That is still being appealed. There are some problems.

Let me give you the employer's perspective. The employer hires people as independent contractors for several reasons. One of his goals is to make the most amount of profit possible with the least amount of cost in so doing. I have a client that is a software development company, and in so doing they find that they get better results and get more timely results by using independent contractor programmers who use their own equipment on their own time but are given deadlines, instead of having workers show up at the office and work at their leisure, trying to work toward a goal and get involved in office politics and other things that delay the progress of their software development.

I also have another situation that indicates some of the problems and some of the nature of feelings out there among businesses. I have a client who is blind, and he trains workers for one of the company's—one of the larger high-tech companies in our country. He is and independent contractor. He works out of his home. He flies to the location and does the training. When it came time to issue his 1099, he got a phone call from this company saying, "I need your employer identification number," and he gave them his Social Security number, and they said, "You know, you really need to consider, and most of our trainers are incorporating."

From a tax standpoint it would not be beneficial for this particular client to be a corporation. He is better off operating as a sole proprietor for some of the different tax deductions he is able to get; namely, being able to pay his children who do some work for him and not have to pay self-employment tax.

We also need to consider that the time has changed. Our economy is much different even than it was 5 years ago. With the downsizing of the Fortune 500 companies, many people contract back with their employers in the initial stages while they are trying to find other work and continue to fill some of the role that they did as employees. If the IRS examined in these situations they are not giving them a chance to grow their businesses to the point where they take on other contracts and are able to hire employees and become tomorrow's larger service-oriented businesses.

Last week I was testifying in the House Ways and Means Committee, and one of the people who testified was testifying on some of the welfare reform. She is from Maryland, and she had indicated that people who she worked with and trained, if they were given the opportunity or were told that their benefits were going to be cutoff on a Friday night, she said they would go out and seek a job on Monday morning, and in that meeting we went so far as to recommend that some of those people—and she recommended that some of those people would even start small businesses, cut lawns, or do other types of work, and they might be industrious.

I think a solution to this problem is not going to be totally feasible, a very workable solution is not attainable, unless we consider the burden of the self-employment tax on the self-employed and the cost of the payroll taxes and cost of compliance to the employers. That is some of the motivation behind gaming. I think most people are honest. I think there needs to be a level of trust between Treasury and workers.

I thank you for your time today.

[Mr. Willett's statement may be found in the appendix.]

Chairwoman MEYERS. Well, I thank you very much for being with us, Mr. Willett, and we appreciate your testimony.

Our next witness is James Parmelee. He is a small business owner, Parmelee Associates, and he is also a member of the National Association of the Self-Employed.

TESTIMONY OF JAMES PARMELEE, ADVERTISING CONSULTANT AND FREELANCE WRITER, ARLINGTON, VIRGINIA

Mr. PARMELEE. Madam Chairman and members of the committee, thank you for having me here today to testify on the issue of independent contractors. I both am one and hire them. I am Jim Parmelee, as you mentioned, owner of Parmelee Associates located in Fairfax, Virginia. We do a lot of work on media relations and political campaigns and freelance writing.

I am not just testifying today based on my own personal experience as a contractor and as hiring contractors but also as a member of the National Association for the Self-Employed. The NASE is a small business trade association representing over 320,000 small business persons from throughout the United States. Over 85 percent of our members are small business owners with five or fewer employees. Many of these employees consider themselves to be independent contractors or utilize them on a regular basis.

Small business owners like myself have long supported clarification of independent contractor status. Most of the support stems from the fear that I have and other small business owners have and the independent contractors have from the subjective and unpredictable nature of the 20-factor test that the IRS currently uses to determine whether or not that relationship, that independent contractor relationship, exists.

I understand, and we have a good example here, that in 9 out of 10 cases the IRS reclassifies the independent contractor as an employee. This scenario typically causes the business who hired that contractor to face costly fines and penalties and most likely the elimination of that job. This results in a very negative domino effect on small businesses. You have first the businesses that utilize these contractors to perform short-term projects and provide short-term expertise become leery of utilizing independent contractors. They decide, well, they just can't do that. The fear has an impact on those who have those jobs because they see businesses staying away from them: Well, we can't afford to hire you as an employee. We would like to have you as a contractor, but we don't want to mess with the IRS. They have more money than we do, they have more time than we do, and they are too much of a problem.

It seems to me that both parties involved in an independent contracting agreement would benefit from the clarification and simplification of independent contractor status. Clearly our economy would benefit from businesses operating more cost effectively, and entrepreneurs creating jobs for themselves by setting up on their own is certainly a goal, I'm sure, of this committee and of Congress as a whole.

In response to the intensity with which the IRS has pursued independent contractor audits, the NASE has previously called upon Congress to take steps to clarify this status. The objective of the policy, I would submit, should be to accommodate changes in the U.S. and global economies toward more, not less, flexibility in employment and contracting arrangements. We need to get the Government as far out of this as we can today, more than ever, as large companies downsize more and more people are reentering the job market by putting their name out on a shingle, by doing what really started this country, going out on their own and trying to do something to try to help themselves and their community.

While both the NASE and I support clarification of independent contractor status, we strongly oppose giving the authority to the IRS to issue regulations however they see fit. We think Congress needs to rein them in a bit. Just like when President Clinton last year proposed giving the IRS more authority during the health care debate, and just like most small businesses did not trust the Government to handle health care, we don't trust the IRS to handle independent contractor status. We have a healthy dislike of authority. Without clear and unambiguous safeguards built into the law, we believe that such a broad grant of authority that President Clinton supports is equivalent to putting the fox in charge of the hen house.

To make decisions on employee classifications, the IRS uses a list of 20 questions, as you know, derived from common law precedence dating back hundreds of years relating to the relationship between an employer and a contractor and a contractor/employee.

Not only is this 20-factor test an antique, the NASE and others in the small business community agree with the Treasury Department, of all people, when we call this subjective. In testimony before the House Government Operations Committee last year, Treasury Deputy Benefits Tax Counsel J. Mark Iwry stated that the 20-factor test has been, "criticized as leading to imprecise and unpredictable results."

Congress grappled with this independent contractor status back in 1978 when it passed section 530, broad legislation addressing the issue of who is and who is not an independent contractor. Congress once again tried to address this issue in the 80's, to no avail.

Section 530 as it stands clearly has flaws, but it did attempt to provide employers with safe harbors for determining who is an independent contractor. This statute also imposes a moratorium on any IRS regulations involving contractor status, and any moratorium on the IRS is a good thing.

The existing law provides most employers with relief from potential IRS reclassification of a firm's independent contractors as employees by prohibiting the IRS from reclassifying such workers if the employer has a reasonable basis for its treatment of the work-

ers as independent contractors. A reasonable basis includes reliance on: First, judicial precedence or IRS rulings; second, a past IRS audit in which there is no assessment attributable to employment taxes; third, a long standing industry practice in treating the workers as independent contractors. However, the reasonable basis protection was revoked for many technical service professionals such as engineers and computer programmers by section 1706 of the Tax Reform Act of 1986, and, as we have seen a tremendous expansion in both of those fields, that is something we need to look at also.

In conclusion, the NASE and I do support the idea of a separate congressional investigation regarding the tax treatment of independent contractors, but we believe that clear objectives must be set by this committee and this Congress before an investigation is undertaken. Any congressional inquiry of this type should be based on the need to foster and promote independent contractor status as opposed to heavily restricting its use. In this regard, although we have not had a chance to review Representative Kim's legislation in its entirety, we commend him for taking on the independent contractor issue for small business and we look forward to working with him and with members of this committee on this vital issue.

The NASE believes that all taxpayers should pay their fair share of taxes. That is why we do support efforts to identify areas of potential abuse with respect to employment classification issues. The NASE supported this endeavor during the course of the health care debate when the authority would have been given to the Department of the Treasury, and we would continue to support such an investigation.

Thank you for your time.

[Mr. Parmelee's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Mr. Parmelee.

Our next witness is Claudia Hill, and she will be speaking for herself and also the National Association of Enrolled Agents.

TESTIMONY OF CLAUDIA HILL, NATIONAL ASSOCIATION OF ENROLLED AGENTS, GAITHERSBURG, MARYLAND

Ms. HILL. Thank you, Madam Chair, Mr. LaFalce, and the House Small Business Committee members.

Chairwoman MEYERS. May I suggest that with our remaining witnesses—I meant to say this at the beginning—if you could try to limit your remarks as close to 5 minutes as you can—if it goes over to 6 the world isn't going to fall, but we have a number of witnesses today, and what I am trying to do is preserve some time so that the committee can ask you questions.

Proceed.

Ms. HILL. Thank you.

I am Claudia Hill from Cupertino, California. I am a small business owner of Tax Ma'am, Inc., in Cupertino, and I represent the National Association of Enrolled Agents chairing their Government Relation Committee.

Our organization are enrolled agents, specialists in representation for small businesses and individuals in issues before the Internal Revenue Service and our members, representing 4 million tax-

payers, are keenly aware of the hardships facing small businesses today when IRS reclassifies independent contractors as employees.

As my fellow speakers have indicated, we have seen the subjective and inconsistent application of the 20 factors, the issues of concern with section 530, and we have seen taxpayers who have tried to comply with the law who have ended up in situations where they have had to pay back taxes and interest and FICA taxes on workers that had already paid and reported their own income and taxes previously, and these are people who had been complying with the law, making efforts and filing their form 1099's information documents. That is why we applaud this committee for taking on the difficult task of creating a reasonable and consistent standard in classifying workers.

The difficulty is in addressing how to encourage the entrepreneurial spirit of small businesses, many of which started as a single independent contractor with a single contract, while providing incentives in the system for greater compliance in reporting and paying taxes on the income they earn.

We also note the current trends in large corporations downsizing and right-sizing, and we are seeing increasing numbers of technical and professional workers finding themselves facing limited term consulting engagements as the only viable work arrangements they are able to find. They need clarification of their treatment for employment status as well as encouragement to form small business consultancies on their own and possibly then creating the midsized businesses of the future.

You had asked us to comment on H.R. 510, the Misclassification of Employees Act. We strongly support the initial thrust of the legislation which creates a waiver of employment tax liability for reasonable, good faith misclassification based on common law rules. We believe this section fairly protects the small businesses who do make a good faith effort to comply with the law as they understand it and who file their information document consistent with their treatment of their workers.

However, we are concerned about the requirement in this proposal that a closing agreement under section 7121 be entered into agreeing to treat any suspected misclassified workers as employees. We believe this section may be used as leverage to force small businesses to comply with IRS characterization even when they have legitimate grounds for asserting the independent contractor position taken. We believe this could happen because the system that exists today does not adequately provide a cost-effective avenue of legal appeal for small business taxpayers, recourse to the U.S. Tax Court, the legal forum in which most individual taxes are taken for appeal, because it does not require payment of the assessment prior to a binding decision, is not available in payroll tax disputes. The problem exists today and would be exacerbated under these proposed provisions.

Many small businesses would not be able to afford the alternative to signing the closing agreement and accepting IRS's determination. In other words, they would not be able to get the money to pay the assessment and then initiate a costly legal appeal in a district court forum, and we believe this issue needs to be addressed legislatively.

Further, we question why the proposed section 3 termination is included. It appears that it would set up a 1-year window for cases currently in process to be resolved but undermine the intent of the legislation. Surely it is not reasonable to think IRS will be able to examine and enter into closing agreements with all small businesses existing today who do not currently understand the law within 1 year.

Regarding the modification to section 530(a), we believe limiting the time period for the prior audit criteria is reasonable. However, limiting it to situations where IRS audited the business solely for employment tax purposes may be too limiting.

Current IRS procedures state that any audit of a small business will include an evaluation of worker status. Permitting IRS to create an extremely narrow exception as defined in section 2 (b)(2)(c)(i) would disadvantage and injure the taxpayer if IRS simply failed to follow its own procedures.

Our concern is furthered by a situation that exists in current programs administered by IRS in this area. IRS is using an examination technique they call a compliance check in which they review a taxpayer's payroll tax returns, information documents, and cash disbursement journals in an effort to determine whether a more complete examination of the worker classification is needed. IRS indicated to our organization that this compliance check was not an audit and therefore does not grant the employer an IRC–550 safe harbor.

We believe this technique is misleading to small businesses involved who certainly feel like they have been audited after the completion of the process, and often they are not given an understanding of their rights to professional representation during these nonaudits. We believe the language as drafted in the section discussed above would encourage IRS in their usage of this technique.

Now we understand that IRS and GAO's driving force behind the concern over misclassification of workers is based on underreporting of income by service businesses. Much of the commentary on this subject focuses on using 530 provisions as a basis for misclassifications. Perhaps the focus should be on what Congress intended in the first place, protecting small businesses from arbitrary IRS reclassification and assessment of taxes and penalties that put them out of business.

We believe that specific guidance and parameters as to the characterization of employee versus independent contractor should come from Congress, not from IRS. We fear granting IRS unlimited discretion to formulate and administer rules governing this area would pose a threat to the entrepreneurial spirit and formation of new small businesses.

We believe the tax gap among service providers can be addressed by an increased focus on third party reporting including increased follow-up by IRS for a situation where there is known noncompliance by the worker payee. The current emphasis on the payer small business places an unfair burden on those businesses making efforts to comply. We suggest a system for voluntary withholding on 1099 payments for nonemployee compensation. Then we would support a system of mandatory backup withholding for known noncompliant providers similar to that which is in effect today in

instances where people fail to report their interest and dividend income. We believe this approach will place the focus where it belongs and not on those small businesses attempting to work within the framework of the system as they understand it.

It is indeed a challenge to create a fair structure that does not place the formation of small businesses on the Endangered Species List, that provides for flexibility in employment contracting arrangements, and still addresses the concern for underreporting of income within this segment of taxpayers.

We thank this committee for having the courage to address this challenge. If there are any questions regarding this, we would be pleased to address them as would our national office, the National Association of Enrolled Agents.

Thank you very much.

[Ms. Hill's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Claudia. We appreciate your being here, and indeed this is an important issue, and I think our response to our hearings on this issue has been as strong as on any single small business issue, so we know it is very important.

Our next witness is Marc Wagner, CPA and an independent contractor representing HD Vest Financial Services.

TESTIMONY OF MARC S. WAGNER, H.D. VEST FINANCIAL SERVICES, PHILADELPHIA, PENNSYLVANIA

Mr. WAGNER. I want to thank you very much, Madam, for this opportunity to represent HD Vest Financial Services and myself at this hearing.

I own and operate my own small accounting and financial services firm in Southampton, Pennsylvania. In that capacity I employ four employees and supervise their activities. But more pertinent to today's hearing, I also act as an independent contractor with a company known as HD Vest. They market investment products and insurance services including mutual funds and other types of policies.

Vest does not sell directly to the public. Instead, it provides marketing support to 5,000 tax professionals just like myself who offer these products to their clients. These 5,000 tax and accounting professionals are independent contractors, and I am a typical example. Like most Vest representatives, I own my own tax preparation business and my own small accounting business. The work I do with Vest is a small part of that overall operation. I work on my own schedule out of my own office using my own staff and equipment to service my clients.

Basically, Vest offers me very little in the way of complete supervision, but I will be a little more specific about that in the future. The fact is that I have hired Vest to provide broker services for me as required by the securities laws and regulations under the SEC. I pay them a portion of my income to provide these services. In a very real sense, they work for me.

I have specifically chosen to be an independent contractor as opposed to an employee with HD Vest and with others that I deal with, specifically, the 60 or 70 small business clients who employ me as their CPA. I have joined millions of others who have chosen

to forego the advantages of employee status for such benefits as just being my own boss. I enjoy the freedom that independent contractor status allows me and I am, first and foremost, an entrepreneur, and my association with HD Vest is only a small part of my business.

Madam Chairman, you have chosen a topic of tremendous importance in today's hearing. The question is whether or not a representative like myself should be classified as an employee or an independent contractor. This has tremendous implications for both myself and HD Vest and the securities industry.

By some estimates, the cost of a worker versus a subcontractor increases by 25 percent. Using HDV as an example of how this would affect business operations, overall costs to HD Vest would have increased by $12.3 million in the year 1993. That is four times larger than the total profit generated by the company and approximately 27 percent of its total revenues. It is not hard to imagine that the company would not be able to survive under that kind of a strain.

Vest is not alone. Tightening independent contractor guidelines would touch small businesses in every corner of this country. The Small Business Administration estimates that there are 5 million independent contractors in the U.S. and that one of three companies, especially small businesses, rely on independent contractors to some degree. These are the SBA's figures, but by my experience I feel they are very law. All of my clients rely on at least one independent contractor, that being myself, and most rely on several others.

Should the legal scheme be improved? Yes, but with a caveat. As a certified public accountant, I would cherish better guidance on exactly who is an independent contractor and who is an employee, but, on the other hand, I am concerned that a change in these regulations would result in a much narrower definition which would unfairly squeeze out small entrepreneurs like myself and HD Vest.

One thing is clear, as alluded to by several of the earlier speakers. If a change is made in this definition, it must be made legislatively and administratively by the Internal Revenue Service. The IRS's hostility to the independent contractor designation is well known and well chronicled. In fact, in 1979 the situation reached such a level that Congress took the extraordinary step of passing a law expressly prohibiting the IRS from writing independent contractor regulations. That highly unusual regulatory moratorium exists today.

But today the IRS is attempting to formulate an end run around that moratorium. They are producing an internal audit guide specifically aimed at the securities industry. In this guide it defines control as being the key issue in determining who is an independent contractor. Part of the services that HD Vest provides for me is to monitor my activities and see that they stay in compliance with the securities laws and regulations. The IRS has defined within this audit guideline that should a perspective employer provide just enough supervisory capacity to make sure the employee stays within the law, that that would imply that person is an employee instead of an independent contractor. So, understand that if I follow the securities law and allow my broker dealer to supervise my

activities and assure that I am in compliance with the law, the IRS will then take that to mean that I am not an independent contractor. We are kind of stuck here in a position where the definitions really get to be pretty tense.

Basically, I wanted to bring out these problems to the committee and thank you very much for that opportunity. I have submitted written testimony which goes into a little more detail, and if anyone has any questions of course I am available to answer them at any time.

Thank you.

[Mr. Wagner's statement may be found in the appendix.]

Chairwoman MEYERS. We appreciate you being here. Thank you very much, Mr. Wagner.

Our last witness on this panel is Cheryl Bass, RN, president of American Professional Temporaries, Inc., and American Professional Home Health, from Parma, Ohio.

TESTIMONY OF CHERYL M. BASS, AMERICAN PROFESSIONAL TEMPORARIES, INC., AMERICAN PROFESSIONAL HOME HEALTH, INC., CLEVELAND, OHIO

Ms. BASS. Thank you, Madam Chairwoman, and thank you, members of the committee, for this opportunity. I appreciate it.

Chairwoman MEYERS. Cheryl, I wonder if you could speak rather directly into the mike because we can hear you but those in back of you can't unless you address the mike.

Ms. BASS. Is that better?

Chairwoman MEYERS. I think so. Yes.

Ms. BASS. Ms. Chairwoman and members of the committee, I am Cheryl M. Bass. I am a nurse and president of American Professional Temporaries, Inc., and American Professional Home Health, Inc., of Parma, Ohio. My companies are among the many small businesses that comply with the employment tax laws by classifying our workers as employees and have been damaged by competitors which misclassify their workers as independent contractors.

My companies are members of the Home Health Services and Staffing Association, HHSSA, which is an association of large and small businesses providing supplemental nursing staff to health care facilities and home health services directly to patients. All of these companies treat their supplemental staffing workers as employees in accordance with the IRS consistent application of the employment tax laws to our industry.

HHSSA is a member of the Coalition for Fair Worker Classification, which is a coalition of associations representing large and small businesses as well as management and labor and who feel that legislation is needed to curb the intentional abuse of the independent contractor designation.

I treat all of the nurses who work for my companies as employees because that is the appropriate designation under the law according to opinions from national staffing and home health associations, experienced legal counsel, and the IRS itself.

In the past several years my companies have suffered severe damage from competitors who provide exactly the same staffing services but intentionally misclassify their workers and independ-

ent contractors. We cannot compete on price with companies that evade the expense of withholding and paying employment taxes, providing for unemployment and Workers' Compensation insurance, as well as complying with the requirements of the Fair Labor Standards Act, the Occupational Safety and Health Act, and other State and Federal laws that apply to employees. In 1 year alone I lost three major hospital clients to companies that undercut our prices by misclassifying their workers.

The abuse of the employment tax laws which I have seen in the medical staffing field also occurs in other fields and is growing, as documented in at least six prior congressional hearings.

If control over the way a job is performed is a criterion for determining a worker's status, the nurses who work in areas such as operating rooms and intensive care wards of hospitals must be regarded as employees in order to protect public health and safety. It is legally and practically imperative for the services of nurses who work in such settings to be provided in accordance with the institution's policies and protocols and as part of an integrated team.

The current situation is untenable. The criteria for distinguishing between employees and independent contractors are notoriously ambiguous. Companies both large and small are increasingly exploiting that ambiguity to obtain an unfair competitive advantage over law-abiding companies, yet a provision in the law at section 530 prohibits clarification. Intentional misclassification is an abuse that we should not have to tolerate and certainly cannot afford.

The General Accounting Office has found that much of the $20.3 billion annual tax gap is attributable to the misclassification of workers. The accounting firm of Coopers and Lybrand recently issued a report projecting that the Federal Government will lose approximately $35 billion over the next 9 years as a result of worker misclassification. At a time when Congress is contemplating cutting spending for Medicare services to the aged and disabled, preservation of a costly loophole in the employment tax laws is indefensible.

As a member of the vast majority of small businesses that properly classify their workers, I request that Congress enact legislation that provides for clarification of the distinction between employees and independent contractors, repeals the provisions in section 530 that prohibits such clarification, and phases out the safe harbors which allow companies to misclassify their workers with impunity.

I have reviewed H.R. 3069 introduced in the last Congress by Congressmen Christopher Shays and Tom Lantos and strongly support it. As I understand the bill, it would: First, establish a process to ensure that the employment tax laws are applied in a similar manner to similar businesses; second, remove the prohibition on the IRS to issue clarifying regulations; third, narrow the section 530 safe harbors to prevent intentional misclassification; and fourth, require taxpayers to inform workers of the consequences of being classified as an independent contractor.

I believe the bill could be improved by fully phasing out the safe harbors after the issuance of clarifying regulations, but it is a large step in the right direction and is far superior to any other legisla-

tive proposal which has been made. In any event, it is clear that legislation curbing abuse of the employment tax laws is supported by Republicans and Democrats, large and small businesses, and management and labor.

I will submit the remainder of my remarks for the record and be glad to answer any questions.

[Ms. Bass' statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Cheryl. We appreciate that point of view.

I think that we will start with questions in the order of arrival at the committee and will start the questioning with—is Mr. Talent here? Yes.

Mr. TALENT. I want to thank you all for being here and thank the chairman for holding this hearing.

One thing that is very clear is that the existing system is not working very well. I dealt with this problem when I was in the State legislature. It has come up in the 2 years that I have been on this committee, it is coming up again, and everybody wants it changed. I think it is appropriate that we have these hearings, and again I compliment the chairman on holding them.

Is it the opinion of the people in this—and you represent a pretty diverse point of view—is it your general opinion that the common law test that the IRS is supposed to follow, that 19 or 20 different elements that they are supposed to look at to determine independent contractor status—is it your general opinion that that test is pretty much unworkable in this day and age, that we need a brighter line test, or could we keep that test and change the process by which we enforce it and achieve a pretty good result?

I ask this question because when I was in the private practice of law I dealt with this in a different context, and I thought that the test itself, if applied reasonably, was reasonably fair and you could apply it to different kinds of industries, but there just seems to me there is great difficulty not only with the IRS but with other agencies that have to enforce this in different contexts with getting results that people don't believe arbitrary.

I know there is a problem from the standpoint of persecuting businesses that have legitimate independent contractor status. Ms. Bass talked about the fact that we don't seem to be adequately enforcing the rules against people who don't, and so just give me your general opinion on whether we should just abandon that test and move on to something else or whether you think it is salvageable.

Mr. WILLETT. If I may start, I would like to respond. The 20-point common law test, as a practicing CPA with a master's degree in tax, I think is a pretty good test. The problem is, there are too many points for the IRS to arbitrarily interpret. I think a reduced number of points would make it easier for a small business to interpret those on their own and maybe do a better job classifying their employees.

The problem is how the attitude on which the 20-point common law test is being applied, and I think there needs to be better trust between business and between the Treasury Department. If there were better trust, I don't think there are outlandish abuses by business owners in this area. I actually think the 20-point common law test allows for some flexibility that small businesses need. I

would rather see the 20-point common law test than some of the H.R. 3068 provisions that have been proposed. I think that becomes a lot more restrictive in the penalties and it is geared toward certain industries. I don't think it is a very effective proposal.

Mr. PARMELEE. Well, I think what you need is something that no one can be subjective about. I don't trust myself or any of you, with all due respect, or anyone to decide these types of question. You have an IRS agent that has had a bad day, you have an IRS agent that doesn't like the type of business you are in, the type of candidates that you consult for. I think that is wrong. I think you are right, write the rules. You can fine-tune some of these maybe and eliminate a bunch of them, but yes or no, black or white, no decision by an outside group, either you have done this or you haven't done it, and I think you need to get away from interpretation.

Ms. HILL. I don't know that I would discard the 20 factors. I think what we see in audit situations is a focus on primarily three of those factors as usually being critical ones that are brought up in an audit situation. I don't think it is reasonable to have 20 factors and tell someone: "Now if you miss one of these you are going to be on employee," but I think they also need to build safe harbors into the system, some protection for people who try to comply with the law.

If the issue is really focusing on the revenue loss from people who don't comply with the law because they don't report their income because they say they are independent contractors, then maybe we should have the focus on making sure that that income does get reported more so and providing safe harbors for people who, because there isn't a line that can be drawn absolutely, you have got different kinds of industries.

Let me give you an example of another extreme. We talk about all the horror stories when people are trying to stay outside the system. The State of California requires dental hygienists to be under the supervision of a dentist. Based on that State law, the Internal Revenue Service came in and said, OK, every hygienist in this State will be an employee. I do the tax return for a hygienist who has 27 W2's. Because she doesn't mean any requirements as an employee to get any fringe benefit coverage, she isn't getting enough benefit there, she isn't covered by any of those 27 employers pension plans, and she is restricted to a $2,000 a year IRS.

So, there is so much latitude, I don't think we can say here's one line.

Mr. TALENT. When the CBO or the GAO talks about the tax gap due to this, what they are not factoring in is the loss of employment incurred because of transaction costs and the higher costs of employment that are forced on employers.

Ms. HILL. Right.

Mr. TALENT. So in other words——

Ms. HILL. That is a good example, 27 people having to do this duplicate reporting for her.

As a certified public accountant, I think the current 20-question test is a workable system if it is consistently applied. I think it does offer some reasonable guidelines as to who is an independent contractor and who is not. I think the abuses of the system come when the Treasury comes in and says, as was pointed out earlier,

if 19 tests say independent contractor and one test says employee, then that person is an employee.

I think these tests have to be utilized in a reasonable manner and applied on a consistent basis, and if they are, I think that will take care of the abuses that are currently out there.

Ms. BASS. I agree again on the idea that consistency is what is lacking in interpretation, and possibly the wording is what—maybe there is some antiquated wording in those 20 rules, but I think I have to, as a business owner and employer of employees, I would like to go back to the issue that, if you don't meet all of those 20 qualifications you are an employee. You know, maybe there are 97 percent of the workers out there who will always fall into employee categories and should have benefits paid by the employer.

Mr. TALENT. Except, as I understand it, and I appreciate your testimony, the purpose of the 20 points is to guide people in resolving the basic question: Do you control the means by which the person does the job or do you just control the result? Then that is just a guide. So, if 19 of them come down on the side of you just control the result and one comes down on the side of you control the means, the normal inference is that, well, basically you just control the result. It is that this is just a guide to a determination of a broader question, is my understanding.

Ms. BASS. That is where the gap in consistency comes then because it is pure interpretation, subjective interpretation.

Mr. WILLETT. I would say it is not even subjective interpretation. I mean the Treasury's goals are to collect as much tax as possible. What better way than have it withheld and collect it every week or every 3 days through withholdings? We are in a different economy. It is a lot more flexible economy. People want to work from their homes, use their own computers, work on their own time schedules, and control their own environment. They may not control their results, and I think that this needs to be looked at.

Again, I think there needs to be added flexibility rather than more restrictions added to the classification category.

Mr. TALENT. I thank the chairman.

Chairwoman MEYERS. Mr. Sisisky.

Mr. SISISKY. Thank you, Madam Chairman.

The problem of misclassification is not the only problem. You mentioned unfair competition, but nonreporting is also really a problem. The Treasury Department, which you said needs to make more money, I think they are losing money. Would you believe that—I think the fine is still there—that if you do not report you only have a $50 fine. It gives incentive for people not to report. That is where the problem lies.

Unfortunately, it is usually the conscientious companies that draw the exorbitant fines. That is, the only way—and I have looked at this thing now over the years—that we are going to resolve this problem, with the 20 questions, the reporting is to raise the fine for nonreportint up to $2,700 or $3,000. But we are going to have to give amnesty over a period of time to let people fall in and say. "This is it after this date," in my belief. I don't think you can do it any other way.

Mr. WILLETT. I think you are right. I think you need to encourage proper 1099 reporting. I don't think the fines are the means

by which to encourage it. I think you are going from a distrust attitude when you say, "If you don't do it, here's your penalty." I think we need to do something to encourage it, and maybe the amnesty is the way to encourage that.

Actually, I was surprised when Treasury said 80 percent of the time people were reporting the income, whether they get the 1099 or not. Without 1099's, people are still voluntarily reporting, 80 percent. So, I don't think the problem is as bad as they may make it sound and it certainly doesn't justify 97 percent reclassification rate. That is extremely broad to the other side when you are trying to get 20 percent to comply.

Mr. SISISKY. I have got some figures here that show that when payments are reported, compliance is 97 percent. The figure drops to 83 percent when it is not reported to IRS, and the difference is between $2 billion and $20 billion a year. That is what the Government, in my opinion, is losing.

Mr. WILLETT. Right, but some people are going to be tax protesters, some people are not going to voluntarily comply no matter what it is reported on, but I think 83 percent is a good voluntary compliance ratio, and I think if the burden of the self-employment tax and the burden of some of the tax rates and the employment taxes were reduced, you might get more voluntary compliance, and that is why I said in my testimony you can't consider this without taking care of the problem with the self-employment tax burden, because you have people out there, and I have a lot of clients who cannot contribute to their own retirement plans because the self-employment tax is the largest tax they pay and it sometimes outpaces their tax on average 2½ times their income tax.

Chairwoman MEYERS. Ms. Hill did you want to respond?

Ms. HILL. I am looking at it from the point of asking a question. If we can put a dollar amount on what we say the difference between the 83 percent that comply and possibly, with 97 percent reclassification, pull in another $2.3 billion, but what cost is it going to be to the small businesses who choose not to work this bay any more, who choose not to form small businesses? I mean there is a cost there. There is a different way of measuring it. If you put this burden of having to treat everybody as employees, you are going to stifle the opportunities for businesses to form.

Mr. SISISKY. They would not be treated as employees.

Ms. HILL. They wouldn't be businesses.

Mr. SISISKY. They would be independent contractors if they meet the criteria

Mr. WILLETT. What you are saying is, if people reported on the 1099.

Mr. SISISKY. Absolutely.

Ms. HILL. If employers who are contractors reported on the 1099——

Mr. SISISKY. You could have a simple solution where you would call the Internal Revenue Service to check on the number, the identification number, of the independent contractor through a telephone service. That would clear you because somebody is paying the taxes, and that person would have an identification number.

Ms. HILL. That is why we would support the withholding on the 1099 compensation paid that way because it would get it into the

system sooner and address that need and still provide the opportunity.

Mr. WILLETT. Your proposal is interesting though, because in one sense it puts a burden on the employer which I think is wrong because the cost to comply then—to verify someone's Social Security number, make sure they give you a valid Social Security number may be good, but the fact of calling the IRS to see whether this person is an independent contractor or an employee and have them marked and classified up front, number one, is impossible, I think, because a worker's classification can change. If someone gets displaced during the year, IRS isn't going to know if they are independent contractors or not, but I think to verify the employee identification number, but beyond that, it is still too burdensome and puts the proof back on the employer. It is too strong.

Mr. WAGNER. Yes, I think one of the problems you have is that under today's situation where there is no clear-cut answer, a lot of employers are reluctant to file the 1099's and open the door to misclassification. We are really encouraging people not to do it because they don't know if they are doing it right.

If we were able to provide better clarification within the 20-rule test on how that is going to be applied, more employers would say yes, this is an independent contractor, I'll file the 1099, and then the taxes would be collected, and I think that what we really need is not necessarily new legislation but just better interpretation of what we have and a more consistent and reasonable interpretation of what we have, and that will solve an awful lot of the problems that we are talking about now.

Chairwoman MEYERS. Mr. Hilleary, you are next in arrival at the committee, and do you have questions you would like to ask the witnesses?

Mr. HILLEARY. Thank you.

Well, I would just like to thank you for coming today, and I don't have any questions for you at this time but may submit some.

Thank you very much, Madam Chairman.

Chairwoman MEYERS. All right. Thank you, Mr. Hilleary.

I am going to ask for maybe a couple of more questioners and then go on to the next panel and have the next group of people direct their questions to the second panel so that we can hear everybody in a timely way.

I will call on Mr. Peterson.

Mr. PETERSON. Thank you, Madam Chairwoman. I will be brief so that someone else could follow.

It is clear that the clarification question is paramount. I was at one time an independent contractor, and I was also a contractor hiring independent contractors, which got me in a lot of trouble, to be honest with you, because I could never determine who was who, and it caused me problems from a liability standpoint and a lot of other things because of the construction industry I was in.

It strikes me that the 20 points are about 16 points too many, that if we can't narrow down the qualification factors in a general sense we ought to be able to do it by an occupational segment, it seems to me, construction services, consulting, or perhaps something else, but it is just too many, because you end up never knowing if you are right or wrong unless you then go to the IRS on the

front page of this thing and then you make a ruling and then you get your determination before you go in, but then that doesn't take care of the competitor problem that you have with your health care thing, which is a very, very real problem, because after this other competitor has knocked you out of all your contracts, you have lost so much money, you can't compete any more.

So, it seems to me that we do have an opportunity here to suggest to the IRS or to our own committee to review these 20 questions and not only look at the idea of paring them down but either making them all or nothing. That is the other part of it. Can you be a little bit right or all wrong in the evaluation of the 20 questions? If you pass the 19—what is the 70 percent test on the 20?

Mr. WILLETT. Arbitrary.

Mr. PETERSON. I know. That is what I mean, and that is the point I am making. We have got to clarify that, because the small business owner, which I still am, really gets in trouble on this from that standpoint, and so I won't even ask the question, I'll just make the statement. It is a problem for us. I think it is a challenge for us in this committee to clarify this issue and stop having everyone out there not knowing if they are breaking the law or not. I think we can at least do that.

Thank you.

Chairwoman MEYERS. Thank you very much.

Mrs. Smith.

Mrs. SMITH. I think I will wait for the next panel, thank you.

Chairwoman MEYERS. All right. We will finish with Mr. LoBiondo.

Mr. LOBIONDO. No questions.

Chairwoman MEYERS. No questions.

All right, let us go to the next panel then and I want to say again I appreciate very much your being here.

Our second panel is with us, and we will be hearing from Don Owen, Keith Fetridge, Wayne Kauffman, Ronald Baker, and Mr. Brick Faucette, and I believe that Mr. Kauffman is a constituent of Jim Talent's, and at this point in time I would like to defer to Mr. Talent.

Mr. TALENT. I appreciate that, Madam Chairman.

Yes, Mr. Kauffman is indeed a constituent and a friend of mine, and I would like to welcome him here to the committee and thank you, Madam Chairman, for inviting him here.

Mr. Kauffman has been in the remodeling business for 24 years. His company specializes in remodeling baths and kitchens and exterior siding, and I say this for anybody in the audience who may have a home in St. Louis and may need those kinds of services, and, apart from that, he has a history of service in his association and in the community at large.

I think he has got a lot of interesting things to tell this committee, and I know he will go into not only the problems that we have already heard about with administering this law, but also the way that those problems demoralize and put off so many honest people who are trying to provide a needed service to people, and that may be the most difficult and exasperating part of this, Madam Chairman, and again I appreciate you for inviting him, and I thank him on your behalf and on behalf of the committee for being here.

Chairwoman MEYERS. Well, we are very glad that you are here, Mr. Kauffman, and I, too have a constituent who is here. Mr. Ronald Baker has a business in Kansas City, Missouri, but I believe lives in Leewood, do you not, and so that makes him from the Kansas side of the line, and so he is my constituent, and we welcome you too.

Why don't we start with Mr. Owen and just move right down the table and proceed.

TESTIMONY OF DON OWEN, P&P CONTRACTORS, ROCKVILLE, MARYLAND

Mr. OWEN. Thank you. Good afternoon, Madam Chairman and honorable members of the group. My name is Don Owen, and I president of P&P Contractors, a drywall contracting firm located in Rockville, Maryland. I am also here on behalf of the Associated Builders and Contractors. We are a national trade association representing approximately 17,500 contractors, subcontractors, materials suppliers, and related firms from all across the country and from all specialties in the construction world. Our diverse membership is bound by a shared commitment to the free enterprise system and the merit shop philosophy of awarding construction contracts to the lowest responsible bidder through open and competitive bidding. It is an honor to be their voice before you today.

ABC appreciates the foresight of this committee in addressing the issue of independent contractor status under the Tax Code. This has been a contentious issue in the past, and ABC welcomes the opportunity to work with you to forge an understanding of the need in the small business group for independent contractors as well as the need for workable definitions.

In the small business world, independent contractors are often the perfect answer to a pressing need for special skills and know how needed for short-term projects. The flexibility an independent contractor provides creates numerous advantages for all parties involved. This arrangement allows the independent contractor to have the freedom to choose his or her work schedule, the small business owner the flexibility to adjust staff demands with business activity, and the consumer the opportunity to benefit from a reasonably priced quality product.

ABC believes that employers should continue to be able to make sound economic decisions about the classification of individuals as employees or independent contractors. It is small businesses who benefit the most from the lawful utilization of independent contractors. They are a good source of labor for projects where the contractor does not need to exercise the type of control that would necessitate the hiring of employees.

In the drywall business, independent contractors are used for very specific tasks such as framing, whether it be metal or wood framing, drywall hanging, and finishing. They are small insured contractors who move from job to job and company to company. They own their own trucks and their own tools, and these contractors greatly value their ability to work independently.

The mark of an independent contractor is that he can control how, when, and where he provides services. Quality is greatly valued by many in the small business world. In fact, many ABC mem-

bers got their start running their own businesses by working as independent contractors. It is not unusual for these individuals to work as employees during regular hours and as independent contractors during off hours and weekends.

There is no better way to become established as a small business than to begin as an independent contractor. My company began this way in the early 1960's, and I know we are pressed for time so I won't go into a long history, but it is a fascinating history. It is the American dream if there ever was one. The founders of my company were two drywall hangers. They barely finished grade school, and now we are one of the largest drywall contractors in the Nation. We are mostly an employee operated business, but we do have some independent contractors. Many of the independent contractors who worked for us over the last 30 years have grown to be very tough competitors in the 1990's, and we are proud of that.

The construction industry as a whole faces a unique problem due to its high number of transient and seasonal workers. Because of the cyclical nature of the construction industry, many in the business could not afford to keep certain specialized trade craftsmen as employees. Sometimes skilled craftsmen are needed several times throughout the year but not enough to warrant full-time or even part-time employment. You can see the burden to my firm if I had to place two or three extra framers on the payroll just to finish a 2-week project.

Under current law, taxpayers must use a 20-factor common law test to determine whether a worker is an employee or an independent contractor. The common law is judge-made law, yet lawyers and judges presented with simple three or five factor tests often have difficulty arriving at consistent results. Imagine the difficulty of a small contractor not trained in the field of law but merely wishing to engage the services of a worker for some project and confronting those 20 factors. I can paraphrase again and say I would agree with the idea of cutting that 20-question test considerably.

ABC also believes that Congress and not the IRS should define independent contractor status. When considering the independent contractor issue, it is critical to distinguish between wrongful classification and misclassification, whatever rules we establish. In construction, wrongful classification can result in a competitive edge. Those companies not paying employee taxes or Workers' Compensation can undercut the competition by offering much lower bids. ABC in no way condones intentional misclassification by businesses who shirk their duties to society and to their workers.

On the other hand, simple misclassification or failure to file a 1099 form can easily occur through administrative error. The penalties should not apply in de minimis circumstances where the taxpayer correctly issues information returns to most of its workers. Why should those who genuinely believe they are within the bounds of an admittedly vague law be treated in the same manner as those who purposefully violate that law to gain a benefit? Innocent businesses who have mistakenly misclassified a worker as an independent contractor could be subjected to back taxes that can literally bankrupt them.

We have talked about the safe harbor provisions in section 530. I will just briefly say that they do protect taxpayers from reclassification if there is a reasonable basis for treating workers other than as employees. This reasonable basis may come from published rulings, a prior audit, or industry practice.

Section 530 recognizes that taxpayers must be able to rely on reasonable methods of classification without risking bankruptcy. Protections found in 530 are invaluable, especially to the construction industry with its long history of independent contractor practice.

In addition to protecting past classifications, ABC believes that the time may be ripe to clear up the fog surrounding the 20-factor test for future classifications once and for all. A clean and simple test that recognizes the valuable role of independent contractors in the small business world would ease the way of the contractor struggling with the classification and make it easier to identify wrongfully classified workers. ABC would support such clarification as long as it preserves the current mutually beneficial industry practice of properly utilizing independent contractors. ABC welcomes the opportunity to work with members of this committee toward that goal.

For example, we should look at the grossly misunderstood questions concerning instructions, control, and integration. Those are three headings of the 20 questions. Those should be three of the questions: Instructions, control, and integration.

Construction projects are like football games. There must be instructions, there must be control, and there must be integration in order to properly sequence the work. All subcontractors, regardless of size, have to work in harmony and therefore must work under a clear plan or schedule. A delicate balance must be struck to avoid misclassification of these individuals when they are simply carrying out their duty to build the project.

Perhaps the emphasis should lie not so much on control by the hiring party but rather on the independence of the worker. The worker's own investment in training and tools, the worker's ability to perform his or her services, and the contract under which the worker operates should all be considered.

Finally, I cannot understate the value to our Nation of strong small business, independent contractor relationships. This is real grassroots empowerment which creates thousands of new small businesses every year. It is a big part of the equation for improving the lives of disadvantaged and minority Americans who are working hard for the opportunities to start their own businesses. They need the mentor factor of small business to lead them in as independent contractors.

This concludes my prepared testimony. I would be pleased to address any questions from the chair or other members of the committee.

Thank you.

[Mr. Owen's statement may be found in the appendix.]

Chairwoman MEYERS. Thank you very much, Mr. Owen.

Our next witness is Mr. Keith Fetridge from Rockville, Maryland.

TESTIMONY OF KEITH R. FETRIDGE, ARONSON, FETRIDGE, WIEGLE, STERN, ROCKVILLE, MARYLAND

Mr. FETRIDGE. Thank you, Madam Chairwoman, members of the committee. Good afternoon.

My name is Keith Fetridge, and I am the director of construction industry services with the firm of Aronson, Fetridge, Wiegle located in Rockville, Maryland. Our company is a small business CPA firm specializing in audit tax and consulting services for closely held businesses.

I also serve as a member of the Tax and Fiscal Affairs Committee of the Associated General Contractors of America, and I am here before you today in that capacity.

The Associated General Contractors of America is a national trade association comprising more than 33,000 firms including 8,000 of America's leading general contracting companies. They are engaged in the construction of the Nation's commercial building, shopping centers, factories warehouses, highways, bridges, tunnels, airports, waterworks facilities, multifamily housing projects, and site preparation utilities for the installation of housing developments. Many AGC firm members routinely contract with independent contractors to perform work in many different States and localities, helping to add to the value of the vigorous competition on construction projects in these markets.

Independent contractors are a particularly valuable resource to the small business contracting community. Small general contractors often choose to employ specialists and look to independent contractors to perform specific related tasks to any job. Thus, it is critical that Congress retain the section 530 safe harbor provisions as currently in effect.

On behalf of the AGC, I welcome the opportunity to testify on the need to preserve the legitimate use of the independent contractor in the construction industry as well as the preservation of section 530. It is common for many contractors throughout the country to employ independent contractors skilled in numerous construction trades. In most all of these cases the independent contractor supplies the tools and materials for the job, owns his or her own vehicles, pays into his or her own retirement plan, and does not require the technical assistance from the general contractor as to how to perform the task. The general contractor's role is to inspect the work as it progresses in order to ensure the job is done properly.

While both my clients and the AGC members practice legitimate use of independent contractors, I am aware that some contractors may be classifying individuals as independent contractors when they should be treated as employees. AGC advocates preserving the use of independent contractors when such a relationship is legitimate.

Worker misclassification is an old issue both for the Internal Revenue Service and employers. AGC has been working with the IRS for the past 3 years to resolve differences related to the 20-point common law test used by both the service and the construction industry to determine proper worker classification. The goal of AGC and the IRS, working together, has been to identify those three or four critical issues for classifying certain worker groups in the construction industry that could be used to determine whether

or not someone should be properly classified as an employee or an independent contractor.

A variety of occupational relationships and job classifications exist in the American workplace and in the construction industry. However, for Federal tax purposes only two classifications exist, a worker is either an employee or and independent contractor.

Significant tax consequences result from how a worker is classified. Some of the tax consequences favor the employee status while others favor the independent contractor status. Section 530 of the Internal Revenue Act of 1978 was put into law in order to protect the historically legitimate use of independent contractors. This statute exists because Congress realized that independent contractors contribute a vast amount of added value to economic production and because it is not fair to change the rules after taxpayers organize their affairs according to the good faith reliance on industry practices or IRS determination.

Congress enacted these protections for a number of reasons, but it is safe to say the legislative history of section 530 supports the view that taxpayers are to be afforded wide latitude in asserting or maintaining independent contractor status. Specifically, these protections were established because individuals not under the control of others in the work place bear all the risk and expense for their employment. They were increasingly vulnerable to the subjectivity of IRS audits in which their treatment as independent contractors had been challenged and after private letter rulings or technical advice memoranda from the service had said they were independent contractors or after they had relied on an established common industry practice.

Consider a situation common to thousands of construction-sites across the country. Individuals contract for short periods with one or more construction companies to perform certain work on construction projects. These individuals own their own trucks, they own their own tools, they pay into their own retirement plans, they are not told how to perform the work. Another contractor in the general geographic region is free to contract with these individuals or others like them to perform the same type of short-term work. By any objective standard, these individuals are not employees of the general contractor, but without the protection of section 530 the Federal Government may determine they are even after both parties have relied on historic industry practice or on prior IRS advice.

Under that scenario, if the Government successfully prevails in a reclassification case against the independent contractor, that individual is then subject to withholding Social Security and employment taxes. This retroactive tax would punish employers who have made good faith efforts to comply with the law.

The current law and rules for classifying workers for purposes of Federal employment taxation are adequate and only need additional clarification. Further, the section 530 safe harbor provisions must remain in effect in order to protect the rights of general contractors and legitimate interests of independent contractors.

Finally, we are hopeful that our work with the IRS to simplify classification criteria under the 20-point common law test will prove beneficial to all parties and result in objective criteria that

will be used to determine proper employment classification in the construction industry.

Thank you for letting me speak today, and if you have any questions I would be more than glad to answer them.

[Mr. Fetridge's statement may be found in the appendix.]

Chairwoman MEYERS. I am sure that we will have some questions, and we thank you for being here.

Mr. Kauffman.

TESTIMONY OF WAYNE KAUFFMAN, UNITED HOMECRAFT, INC., ST. LOUIS, MISSOURI

Mr. KAUFFMAN. Madam Chairman, honorable members of the committee, I am thrilled to be asked to provide testimony on the issue of independent contractors. The treatment of independent contractors is probably the most important issue to the home improvement contractors. Both IRS and State determinations in this regard often put remodeling firms out of business, and I have seen it happen.

My name is Wayne Kauffman, and I am the co-owner of United Homecraft, Inc. United Homecraft is a full service remodeling firm located in St. Louis, Missouri, specializing in kitchens, baths, replacement windows, and all types of exterior siding. We have approximately 35 employees and utilize 20 to 40 independent subcontractors throughout the year. I presently serve as the ethics committee chairman of the Greater St. Louis Chapter of the National Association of the Remodeling Industry, and I currently serve as the Government Affairs Committee vice chair for the national NARI board of directors.

Independent contractors are an important part of the home improvement industry. Small business general contractors, many of whom started out as independent contractors, commonly contract with specialized trades craftsmen to fulfill certain aspects of a larger home improvement project. Independent contractors or subcontractors are well suited to serve in these situations. They provide general contractors such as my company with flexibility and cost efficiency in offering varied multiservice projects to the homeowner.

Subcontractors are a very independent breed. They prefer to pick and choose which projects they would like to work on. They want to be their own boss. They do not want to be employees. That is why they have struck out on their own.

For years, remodelers have struggled with the confusion surrounding the definition of an independent contractor. Despite the congressional moratorium issued in 1978, the IRS continues to aggressively audit and reclassify subcontractors as employees for Federal tax purposes. It is obvious that a bias exists in favoring employee status rather than allowing entrepreneurs to remain in business for themselves. Congress must now enact clear, fair, and objective standards and put an end to the confusion once and for all.

State employment commissions can be even more relentless. I myself have undergone such an audit. In 1989 we were audited by two State officials. Initially they reclassified as employees every single person that we treated as an independent contractor. They even reclassified people who had their own trucks and tools, their

own Workers' Compensation insurance, and general liability certificates, and their own Federal ID numbers. After reviewing all the records, the final assessment was whittled down to $1,600. We protested and waited for our hearing. This went on for a number of years with interest accruing.

In 1993 the IRS got wind of our case. They agreed that the findings of the State audit were correct and assessed an additional $3,000 and levied our bank account. This made my banker very nervous. Keep in mind, our hearing was still pending. What is odd is that the State criteria are quite different from the IRS criteria, yet the IRS did not conduct a separate audit.

To make a long story short, after spending over $4,000 in attorney fees, we finally settled with the State for approximately $2,C00. Our total cost amounted to $9,000. I was not pleased with this resolution, but we had to move on.

I know of others with even worse stories. One company called B&L Construction underwent an intensive 3-week employment audit by the IRS in 1990. The initial finding concluded in the assessment of a few hundred dollars, which was paid. About a month later the IRS said they would not accept their own audit and now wanted $80,000. After considering attorneys' fees, time, and effort, the company sought a settlement, so they settled for approximately $20,000, and the IRS promised they would not return to this matter, but they broke their promise and they came back time and again. This company just received another assessment of $17,000. Recently the owner, Bill Peterson, said he couldn't take it any more. His breathing became difficult, and he died on the way to the hospital at the age of 61, and he was not a sickly man.

I asked others to submit their stories, and this is sad, but, truthfully, they are afraid to come forward for fear of further scrutiny. With your permission, I would like to submit these stories for the written record.

So, the question remains what to do. I think given the new congressional climate, the time is right for Congress to tackle this issue and provide small businesses and the IRS with clear guidance that will allow us to easily determine who is and who is not an employee. A number of options should be considered including, one, enact a new safe harbor test. NARI is working with a coalition headed by the NFIB and the SBLC in developing a new independent contractor safe harbor test that is simple to understand and implement. The draft legislation is in the final stages and should be available very soon. For now I would like to urge the committee to seriously consider such a bill. The proposal will allow general contractors to continue to use independent contractors as dictated by their business needs without fear of repercussion.

Change the IRS focus to matching form 1099's with reported income rather than reclassifying workers. The IRS should concentrate on matching forms 1099 with the actual income reported by independent contractors. The information is out there. General contractors have a significant incentive to file their form 1099. Otherwise, their subcontractor costs may not be treated as a legitimate business expense. As long as subcontractors are paying their fair share of taxes, the business relationship should be left alone. If the subcontractors are underreporting their income, then go after

them, don't penalize the general contractor simply because he may have deeper pockets or can be easily located.

Institute consistency in enforcement. Compliance should be enforced consistently. It seems that the IRS likes to set an example in a community by aggressively penalizing one company. The news spreads like wild fire in hopes that other similar companies will be frightened into hiring their subcontractors as employees or just not using them in the future. All subcontractors should not be reclassified as employees simply to benefit the IRS in revenue collection or the administration in providing employee benefits.

With respect to the newly introduced H.R. 510, the Misclassification of Employees Act, I consider this bill a direct attack on the economic freedom of small business owners and individual entrepreneurs. It appears to assume that any business that utilizes subcontractors has misclassified them and is doing so simply to circumvent employment tax laws. The bill offers amnesty for taxes and penalties to employers who have wrongly misclassified their employees who file correct tax information and who promise never to use subcontractors again. Amnesty programs operate under the assumption of guilt. The use of independent contractors is neither an unintentional or willfully wrong act that warrants the need for amnesty. I strongly urge this committee to oppose such a proposal.

I appreciate the concern of this committee and truly hope that action is taken soon to clarify the rules regarding the definition of independent contractors. It is extremely difficult for small business owners such as myself to continue to operate under such a cloud of uncertainty.

Again I thank you, Madam Chairman, for inviting me to appear before you and your committee today to bear witness to the need for clarification of this issue. I am willing to answer any questions I can.

[Mr. Kauffman's statement may be found in the appendix.]

Chairwoman MEYERS. Your testimony was very helpful, Mr. Kauffman, and thank you.

Mr. Baker.

TESTIMONY OF RONALD BAKER, BGM INDUSTRIES, KANSAS CITY, MISSOURI AND BRICK FAUCETTE, PERIMETER MAINTENANCE CORPORATION

Mr. BAKER. Thank you very much. Good afternoon, Madam Chairwoman and members of the committee.

My name is Ronald Baker, and I am the cofounder of BGM Industries located in Kansas City, Missouri. We do business throughout the State of Missouri, in St. Louis also. We do business throughout the State of Kansas in Topeka, and I have been a resident of Leewood, Kansas, for 25 years and have had the honor of having Representative Meyers represent us for a number of years, and I personally thank her for the invitation to come and speak before the committee this afternoon.

It is my pleasure to appear before you today not only as a small businessman concerned about the future of my company but as the president of the Building Service Contractors Association International. I am submitting written testimony for the record but

would like to make some personal comments and observations in addition.

Accompanying me this afternoon is Brickford Faucette of Perimeter Maintenance Corp., of Atlanta, Georgia, and Brick is the chairperson of our BSCAI Government Affairs Committee. BSCAI is an association of companies predominantly involved in the contracting of janitorial services and is incorporated as a 501(c)(6) trade association. We are currently headquartered in Fairfax, Virginia. We represent an industry today within our association of 3,000 members who are predominantly throughout the United States but we do have some worldwide representation.

The issue before your committee represents one of the most pervasive problems in our marketplace today, the practice of employers misclassifying their workers as independent contractors. In the building service contracting industry this practice is most often referred to as illegal subcontracting. As a result, the building service contracting industry, along with other service and construction industries, have been operating on an uneven playing field for years. This silent killer is affecting that, according to the Department of Labor projections by the year 2000, our industry, the building service contracting industry, will create 555,000 new jobs to have a total work force of 3.45 million employees.

Congressional hearings have documented in the past that employers who exploit the ambiguities in the employment tax laws by intentionally misclassifying workers or evading enforcement efforts under the protection of section 530 safe harbors do severely impact the law abiding taxpayer. They deprive the Federal and State governments of employment tax revenues as well as the benefits that rightfully are due to men and women workers in every part of this Nation. During congressional hearings last year this issue came to the forefront in the health care debate and even raised greater concern among law abiding building service contractors.

As a result of the effort of the Coalition for Fair Worker Classification, of which BSCAI has been an active participant, it has been documented by the firm of Coopers and Lybrand referred to earlier today that misclassification of employees as independent contractors, misclassification, will cost the Federal Government $35 billion over the next 9 years.

A copy of that study which has been provided as addendum A to our testimony we would like to respectfully have submitted for the record. That study confirms that in the service sector alone there will be over 2.1 million workers misclassified by 2005, representing a 60 percent increase over the last 21-year period.

Representative Meyers, in your letter to me you asked me for an analysis of H.R. 510. In reading Congressman Shays' testimony, it would appear that H.R. 510 meets our needs. It would develop a level playing field, put one in place, whereas today our company faces competition from contractors who misclassify their workers intentionally. This legislation would appear to be helpful.

In the everyday world, our firm has lost bids to firms who intentionally misclassify their workers. We complain to the customer, but the customer doesn't pay any attention. They have saved between 20 and 30 percent on their bill. We complain to the Internal

Revenue Service, but the Internal Revenue Service has limited resources. They can't check and follow up on every single thing.

Those who engage in misclassification of workers in our industry gain an unfair advantage in competitive bidding because they do not have to pay the FICA's the FUTA's, all the pension, all the benefits that are legitimately required to be paid for workers.

In the real world, many of our employees in our industries are immigrants or they are poorly or undereducated individuals. Many are not even aware of the benefits or of their obligation to pay taxes if they are misclassified as a subcontractor. H.R. 510 is a start. It will help. But if this topic is not faced, you will force our industry, our company, where the practice has been to classify employees as employees, to change. We will in our own company and our industry have to look to level the playing field, and that means finding a way to make our employees subcontractors. That is not what we want. On behalf of my own company, on behalf of our industry, put more definition in the law. H.R. 510 appears to be a start, a good start.

Thank you very much, Madam Chairwoman, for the opportunity to testify today. Like you, I don't want more Government, just good Government.

It is my pleasure at this time to be able to ask Brick Faucette, the chairperson of BSCAI's Government Affairs Committee, to say a few things.

Chairwoman MEYERS. Brick, it is good to have you with us.

Mr. FAUCETTE. Thank you.

Madam Chairwoman and committee members, it is my privilege today to testify to you not only on behalf of my company of 500 employees from Atlanta, Georgia, but also the thousands of building service contractors across the Nation who continue to suffer the consequences of an unlevel playing field.

With the chairwoman's permission, I would like to briefly discuss the current situation my company is experiencing in Atlanta as well as others throughout the United States regarding the misclassification of workers as independent contractors.

Bidding in my company and our industry is generally done on a contract bid system. Commercial building owners or tenants solicit bids from potential cleaning companies. Interested companies in that market submit bids, and the owner or tenant then accepts the bid which best meets his or her need. Usually that involves price. Based on our knowledge and experience, the typical cleaning company in the building service industry treats its workers as employees, not independent contractors. This is the prevailing industry practice, certainly when viewed on a national basis. We also believe this to be the case with respect to nearly all individual local markets. We have submitted correspondence to the IRS on this point. It is attached and marked Addendum C.

As we discuss today, the IRS uses 20 common law factors to determine whether a worker is an employee or an independent contractor. We believe that under any reasonable interpretation of this test the workers in our industry are employees. The misclassification problem occurs in our industry when a firm bidding on a cleaning contract treats all of their employees as independent contractors. A firm bidding on this basis has an obvious

competitive advantage over a firm bidding based on classifying its workers as employees. The firm supposedly treating its workers as independent contractors does not have to concern itself with the various labor burden costs such as FICA, Federal or State unemployment, Workers' Compensation, and general liability. The subcontracting firm also does not have the administrative costs associated with tax compliance for employees. This package of costs varies from State to State but is generally in the range of 20 to 30 percent of the contract price. It is a heck of an advantage.

The problem appears to be growing worse as more and more local markets as mine are affected. In some cases, such as in Atlanta, Houston, and Dallas, the subcontracting practice has become so prevalent that it may, absent action by Congress and/or the IRS, become the de facto prevailing industry practice in those markets.

Previous congressional testimony has addressed in detail the harm done to the workers involved in misclassification. We think the harm is fairly obvious. While a worker so misclassified may gain the temporary advantage of not having his or her wages subject to withholding, that worker loses a number of benefits and protections such as Workers' Comp, unemployment insurance protection, and the employer contribution to Social Security.

I would also add that the workers involved, at least in our industry, are often recent immigrants and quite possibly illegal immigrants to the United States who are even more subject to potential abuse because of their unfamiliarity with the language and law. Clearly workers lose out when their status is misclassified by an employer. The Federal, State and local governments, I would also add, lose substantial amounts of tax revenue.

We believe that it is not a coincidence that our problem with illegal subcontracting began around 1978 when Congress added the safe harbor provision to the Tax Code. While we can't prove this, I think you will agree that the coincidence is striking. The prior audit provision, in particular, has proven to be a problem. It is our understanding that a company which has undergone a prior audit is then protected indefinitely from an IRS inquiry concerning the classification of that company's workers. We understand that this is true even if the audit was for something other than employee classification. We believe that this provision rewards a company misclassifying workers. It is unfair to competing firms. It is bad tax policy. It harms work workers. It harms Federal, State, and local governments through lost tax revenue.

We do our workers no favor if we rob them through misclassification as independent contractors of Workers' Compensation, unemployment insurance, disability insurance, protection under the Fair Labor Standards Act, the Occupational Health and Safety Act, the ADA, the Family Medical Leave Act of 1993, and protection through the Equal Employment Opportunity Commission, which have all been erected by the Federal and State governments over the last half century.

Congress should pass legislation that clarifies with legislative and regulatory oversight the resolve of a long standing issue that to date has handicapped the entrepreneurial spirit of the small business owner, deprived employees of benefits due them under the

law, and robbed Federal and State governments of much needed revenues.

While BSCAI's membership has not had the opportunity to review and evaluate the details of H.R. 519, it appears that H.R. 510 would go a long way toward solving our problems. We have in the past and will continue to support legislation that would clarify the ambiguities of current employment tax law as it relates to the definition of employees. In particular, we support the elimination of the prior audit safe harbor provisions under current law. This is probably the most abused in our situation, the prior audit.

We also support vigorous enforcement and audit action by the Internal Revenue Service to ensure proper classification of workers as employees when appropriate under the applicable law. We feel that an amnesty program for employers who have misclassified but relied on prior audit protection of 530 would be a positive and useful step in helping correct the current cases of misclassification. By clarifying the employment tax laws, Congress has the potential to generate billions of dollars in revenue at a time when it is so desperately needed. This Congress should not expect law abiding companies to shoulder increasing financial responsibilities while competitors providing similar services are allowed to evade these responsibilities.

There are few who argue the important role that American small business will play in the future growth and stability of our economy. Too often our efforts to create economic growth and new jobs are interrupted by inequities of our own creation, in this case ambiguities in employment tax laws. In the interest of securing not only our Nation's economic best interest but that of American small business, it is our hope that this committee and this Congress will act with the expediency and commitment in resolving this long standing issue.

On behalf of my company and our employees, our association's president, Ron Baker, I would like to thank the members of the committee for the opportunity to participate in these hearings and applaud the committee chairwoman for recognizing the importance in addressing this issue in this Congress.

Thank you.

[Mr. Baker's statement may be found in the appendix.]

[Mr. Faucette's statement may be found in the appendix.]

Chairwoman MEYERS. Well, thank you very much, Mr. Faucette. We are glad to have you with us, and I will recognize for questions Mrs. Smith.

Mrs. SMITH. Thank you, Madam Chair.

I am listening to all of you and becoming more and more confused. I think one thing I hear is the law needs to be changed. I heard one person in the prior panel say that the 20-point criteria may be reasonable, but the biggest question is I have sat in this situation for nearly 11 years at the State level—it appears to me that there is some turf going on, that there is some big versus small entrepreneur, and I come out of the little, the mom and pop, that figures out any way they can, if they have to attach to a big company for a while, they will do it so that they can get started, and that is where I come from, and the big were always trying to

say, well, they are not doing it right. Heck, we were just doing it whatever we could to make a living.

When I look at that kind of a background and I see some of the ones that oppose the small entrepreneur, I get the feeling that maybe we are talking about keeping the mom and pop from starting up by stopping them from the opportunities that are now creating a lot of the jobs in my district.

I know a young man that attached himself, subcontracting, to anybody he could, started a janitorial business, added his mother, added his brother, and as they went, they were able to separate and become their own. But it appears to me that the company they attached to—I mean you might not like him around. Are we talking about that? I guess that is pretty strongly stated, but are you just afraid of competition?

Mr. BAKER. Not at all, Mrs. Smith. We are in favor of legitimate subcontracting, but I guess our concern—and we all started small. I mean I started during my high school and college years. I have cleaned restrooms, I have mopped floors, I have buffed floors, and I have had my hands inside toilets. But there is a legitimate contractor and a legitimate subcontractor, and we use legitimate subcontractors in our business to perhaps perform a special service such as the subcontracting of all the window cleaning in a building to a particular company, and they furnish us with liability insurance and certificates of Workmen's Compensation.

But what we are talking about is the intentional misclassification of employees as subcontractors to where Company A submits a proposal to Representative Meyers to clean her building, and it is a 4-story building, and in that building they employ four people to clean each floor, and they pay them, we are going to call it $20 a night, and they subcontract the work to them, and there is no insurance provided, there is none of the traditional test of a legitimate subcontractor provided, and what occurs, is, when a legitimate company, whether they happen to have 20 employees or 2,000 employees, then goes to bid on Mrs. Meyers' building and they bid, whatever it is, 4 people, $5 an hour, $20 a night, their cost is not $20 a night, their cost, for the legitimate company, is about $25 a night, because I have to pay FICA's, FUTA's, I have to do all the record keeping, I have to comply with all the laws that Brick has talked about.

We are not against legitimate subcontracting, and we all started small, and in our own company I have started three other folks who used to work for us and have got them started and have placed them in the business as they retired off of their primary jobs and they worked for us part time. I pushed them to go ahead in their own business.

But it is the misclassification of workers on an intentional basis that clean a 2-story building, a 1-story building, or a 20-story building in downtown Atlanta or in downtown Kansas City or in Topeka, Kansas. That is what we have a problem with, because that is bad for all of us.

Mr. FAUCETTE. Let me just add one comment on that. Are we afraid of competition? Certainly not, and the problem that we are facing in our industry really is at the other end of the spectrum. It is the big companies doing this. That is where the big problem

is; very, very large companies doing it; and, quite frankly, making a lot of extra money.

Mrs. SMITH. Well, thank you. I am just more concerned about that, stopping that person.

In the Northwest we don't have any jobs left because the timber industry has kind of been shut down by the environmentalists, and so we have this issue of people just out there scrapping, and they will attach to anything to work, and the subcontractor issue has become bigger because people want to work, and so I am concerned about making the law so that they can't work.

So, I understand what you are saying, but I am sensitive also to the other end.

Mr. BAKER. We wouldn't want to restrict competition in any manner whatsoever, but, as Brick said, there are companies in Dallas, Texas, that have branches in 10 cities and they go about hiring immigrants in each of these cities, and they transport the worker from Dallas, and they bring the workers in from various parts of the Southeast, the Asian community overseas.

I had a call from an individual in Washington, DC, an attorney, who, when she knew that we were faced with what we will call misclassification of workers, said to me—and I would be happy to supply on a confidential basis this person's name to the chairman—said to me, "I understand that you face misclassification of workers and subcontractors as competition. For $2,000 we will supply a worker to you. You do not pay the $2,000, the worker pays the $2,000. They will come to work in this country on a work permit. They will have to work for 2 years," I believe, if I remember the exact conversation, "before they get a green card. If they do a poor job, you can classify them however you want. If they do a poor job, you may send them back to Korea and I will get you another worker and you owe me nothing; the new worker who comes over pays the $2,000."

That is the kind of competition on an organized basis that we as legitimate contractors are facing around the country, and that is our concern.

Chairwoman MEYERS. Thank you.

Mr. Luther, would you have any questions at this time?

Mr. LUTHER. No, I do not. Thank you.

Chairwoman MEYERS. All right.

I would like to recognize Mr. Talent.

Mr. TALENT. Thank you.

Let's go back to that subject a little bit. You are not saying that it is impossible to legally do this kind of business with subcontractors, are you?

Mr. BAKER. No, absolutely not, Mr. Talent.

Mr. TALENT. If the IRS audited these people, how many aspects of the 20-point test would they fail, in your view? All of them? Half of them?

Mr. BAKER. Over half of them. In the cleaning industry they would fail over half of them.

Mr. TALENT. So these people aren't providing their own tools?

Mr. BAKER. No.

Mr. TALENT. They are not setting their own schedule. The employer isn't saying to them: "Look, you clean this floor. We don't

care when you go at night or when you leave." So the employer is controlling when they show up?

Mr. BAKER. Yes, sir.

Mr. TALENT. Do they report to the employer's work site or do they report directly to the job site?

Mr. BAKER. They report directly to the job site.

Mr. TALENT. That would be a factor indicating

contractor.

Do they work for more than one general contractor?

Mr. BAKER. No.

Mr. TALENT. So that is a factor indicating employee.

Mr. BAKER. Typically no.

Mr. TALENT. I am not so sure there is disagreement here because these other people have testified in instances where the IRS goes in and finds, well, 19 out of the 20 tests indicate that this person is a contractor, OK, but we are going to find that they are an employee, and the question I would like to ask the Treasury people when you get them here, Madam Chairman, is why they are concentrating on these people and harassing people who are using legitimate contractors instead of going after this, which seems not only a violation of the tax codes but also very probably a violation of the immigration laws as well.

Mr. BAKER. Absolutely.

Mr. TALENT. I think you are just making the point that these people aren't qualifying with the common law tests. It would be easy to find that out with an audit, and the IRS is spending its time——

Mr. BAKER. That is exactly correct. The kicker in this situation is that some of these companies who have grown to be extremely large a number of years ago may have undergone an audit, and they were investigated for something entirely different, and the IRS did not question at that time the way they treated their workers, and they have safe harbor, so now they have gone across the country, whether it be in California or whether it be in Texas or whether it be in Atlanta, and, sad to say, whether it be in Kansas City, Kansas, or Johnson County in the College Boulevard Corridor, they are practicing this illegal classification of workers.

Mr. TALENT. I appreciate the testimony. I think you have made an important contribution, and maybe that is an indication if this safe harbor provision isn't the best way of doing it or maybe that we ought to carve out an exception based on time, or there may be some industries where it is more difficult to use contractors instead of employers, and you made the point that you all are in maintenance and these other people aren't. It would be interesting to look into this at greater length.

Mr. BAKER. Mr. Talent, last year I visited Senator Dole's office and talked to Senator Dole's office, and I guess what we are seeking is also guidance because our industry would be happy if there were industry-specific legislation to correct the problem in our industry, and that certainly would be a possibility.

Mr. TALENT. I would like to see you get together perhaps with some of these other coalition people to make sure that your interests aren't compromised, because they seem to me to be very legiti-

mate, and then maybe we can move forward and do something in the nature of a broad-based solution.

Thank you, Madam Chairwoman.

Chairwoman MEYERS. Thank you.

I think Mr. Owen wanted to respond to your question, Mr. Talent.

Mr. OWEN. Yes. I just wanted to add that I think it is pretty clear that all 10 of the panelists, we all spoke against willful, wrongful misclassification. It is sometimes a problem in our business. It is certainly a problem in the building services business. I think it might be prudent to look at different industries as you are looking at this issue.

The construction industry has long been kind of a fun, easy pickings on this issue, and it is very simple for us keeping the honest people honest. It is very easy for us to clearly classify independent contractors and employees, but you do have these cases like the gentleman from St. Louis where things are way out of balance for him. He is in an industry that is very similar to ours. They are clearly working with independent contractors, yet they are being judged as employees.

So, I think you need to look at this industry by industry. That makes it more complicated. But our industry is fairly cut and dry because it is so dynamic. We are in different jobs, different jurisdictions. Buildings are in set places, and those people go and clean those buildings every night for a month, for 6 months, for a year or 2 years, whatever.

Mr. TALENT. Mr. Owen, I have talked to too many people both in this job and other jobs who I know are not lying to me. I mean these are civic, upstanding people who report cases like Mr. Kauffman reported. I have talked to too many of them to believe that this is not a widespread problem with how the IRS is enforcing this, and this arrogance on the part of the bureaucracy may be the worst aspect of it. Mr. Kauffman referred to this briefly. Not only do they come down on people unfairly and arbitrarily but now—and this is really odious—the last 5 years of getting into this—5 or 6—if you object, if you call a congressman up, we are really going to come after you and shut you down then. I mean it is like being in the Soviet Union, and this is happening in this country right now.

That is one of the reasons this hearing is so important, Madam Chairman, and I thank you again.

Chairwoman MEYERS. I think it is important. Thank you, Mr. Talent. I think it is important, and I believe that we had some people who we asked to be with us today and they said they were reluctant to because they were concerned.

One of the things that I would like to do is change this atmosphere of being afraid of your own Government. If there is anything that we can do to clarify this situation, obviously it is going to be a real challenge. I think our challenge is to make specific proposals and to clarify this law. We have had some good suggestions today. We have had some people who said the 20 guidelines are all right, and we have had some people who said there are so many here, it is almost an invitation to fail and we need to narrow it down and

have fewer guidelines. We have had people who have said that H.R. 510—is this from the last session or this session?

Mr. KATRICHIS (COUNSEL). This session.

Chairwoman MEYERS. This session—is a bad bill that starts from a premise of guilt on the part of the employers, and we have had people who say that it is a good basis on which to build.

We obviously need to take some steps. If we have someone who is getting 27 different W2's, as we heard from one of our witnesses on the first panel, who is a legitimate independent contractor, and if we are actually encouraging people not to file or discuss in their filing that they have independent contractors because they are afraid that they are going to do it wrong, we need to be a great deal more specific about what we are going to do.

So, this hearing is a good basis from which to start. We will have other hearings in the future, and certainly we will hear from the IRS, but when we hear from the IRS we will have your information as a basis on which to listen to them, and so I appreciate your being here very much, and I think it has been very beneficial to the committee, and unless there are further comments, for the good of the order we are adjourned.

Thank you very much.

[Whereupon, at 4:05 p.m., the committee was adjourned, subject to the call of the chair.]

APPENDIX

STATEMENT OF CONGRESSWOMAN EVA M. CLAYTON
BEFORE THE COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES
"TAX POLICY AND INDEPENDENT CONTRACTOR STATUS"
Thursday, January 19, 1995
2:00 p.m.

Madame Chairwoman, This committee has been convened today to address the issue of the status of independent contractors. We all can agree, I believe, that under current law the criteria under which independent contractors are defined is both too ambiguous and vague for consistency in the application of the definition. This ambiguity in the definitional criteria of independent contractors has very serious consequences both for the Treasury Department and Small Business. If, for example, a worker is classified as an independent contractor by his employer, then the employer does not have to pay that employee's social security taxes, nor his unemployment compensation, nor provide for his pension. Furthermore, under this classification the worker does not fall under the protection of federal labor law relating to such critical issues as discrimination and overtime compensation. But, perhaps, the most damaging aspect of this vagueness, is the very large loss in tax revenue by the Treasury Department. In America today, many small businesses wrongly classify thousands of American workers leading to the loss of millions, if not billions, of dollars in tax revenue. In order to recoup these losses, the IRS has used audits to fine those employers who have openly violated the law. But as you know the audit system is in itself arbitrary and tends to lead to greater conflict and suspicion between both the Treasury Department and Small Business.

It is our task today to seek a process which will impose a greater degree of clarity in the definitional criteria of independent contractors. That will likely require the enactment of new legislation that would allow for the consistent application of this definition, freeing small businesses and entrepreneurs from existing burdensome federal legislation. At the same time, however, we must be aware of the responsibilities that employers have to their employees. We must not allow businesses to circumvent the regulatory controls of the Federal Government when it comes to such central issues as discrimination, collective bargaining, and overtime compensation. We must not punish those businesses which are conscientiously obeying the law by allowing other businesses to gain an unfair competitive advantage by fraudulently claiming independent contractor status.

Congress of the United States
House of Representatives
Washington, DC 20515

STATEMENT OF CONGRESSMAN TOM LANTOS
ON HR 510, THE MISCLASSIFICATION OF EMPLOYEES ACT

January 19, 1995

Madam Chairwoman and members of the Committee, thank you for giving me the opportunity to say a few words about the employee/independent contractor classification or the classification of workers.

As I look over the witness list for today's hearing, I see that you have before you an impressive panel of small business men and women who will no doubt describe to you some of the important reasons why Congress should take another look at how workers are classified for Federal income and employment tax purposes, as well as for many non-tax purposes.

You will undoubtedly hear testimony today from small businessmen and women that confusion with employee classification rules can lead to costly disputes with the IRS with devastating effects for small businesses. These costs include, among others, assessments of back taxes, interest and penalties for businesses who misclassify workers as independent contractors, as well as the legal costs involved with coming into compliance or for defending against an IRS audit.

I would like to focus on three other issues relating to the misclassification of workers and solicit your support of legislation my colleague, Chris Shays, and I have introduced to remedy some of the unintended effects that arise out of the current procedures for determining who is an employee and who is an independent contractor. I would like to talk briefly on the effect of misclassification on the unsuspecting worker, the effect of misclassification on the honest

businessman trying to compete with a competitor who has misclassified his workers, and the effect of misclassification on the federal budget deficit.

But, first, I would like to make clear that I agree with and recognize the appropriate and valuable roles of those who work as independent contractors. This country has benefitted greatly from the spirit and independence of the self-employed individual and I do not think there is anyone who wants to stifle the creativity of these individuals. It is the misuse of the independent contractor status and its serious adverse effect on both employer and worker that concerns me.

My colleague, Chris Shays, and I became interested in the classification of workers several years ago when we served together on the Employment and Housing Subcommittee of the Government Operations Committee. We found that the current means for determining employment status has had several negative effects: one, it results in similarly situated employers being treated very differently under tax law; two, it allows -- and actually encourages -- businesses to undercut competitors through unfair practices; three, it leaves some workers exploited and unprotected; and four, it deprives the Federal government of significant revenue.

Under current law, workers are classified as either employees or independent contractors in one of three ways. First, some workers are explicitly categorized as either employees or independent contractors by statute. Second, workers may be classified as independent contractors under statutory "safe harbors" enacted in Section 530 of the Revenue Act of 1978. Third, if a worker is not classified statutorily, and cannot be classified under the statutory "safe harbors", then the worker is classified by applying a very subjective common law test. Most workers fall under this third category.

My colleague, Chris Shays, and I have introduced legislation, H.R. 510, to remedy some of the unintended effects of the current law.

First, current law gives some companies an unfair competitive advantage over other companies in the same industry by permitting employers to misclassify workers if they have a "reasonable basis" for classifying employees as independent contractors. An employer may rely

upon a prior IRS audit, including audits not made for employment tax purposes, in holding a reasonable basis for classifying workers. It makes no sense to permit the wrongful classification of workers based on a previous audit which may have had nothing to do with the issue of worker classification. Our legislation eliminates the "safe harbor" provisions which allows the misclassification of employees to continue. We thus restore a level playing field and eliminate the unfair competitive advantages which arise due to the misclassification of workers.

Second, because the common law test is extremely subjective, employers have trouble in properly determining worker classification, and revenue agents often classify workers differently even where the underlying circumstances of their employment are the same. Since a large part of the misclassification of workers is due to a lack of understanding of the laws, clearer rulings and definitions will eliminate a tremendous amount of uncertainty in this area. Our legislation eliminates the restrictions of the IRS to draft regulations and rulings on the employment status of workers for tax purposes.

Third, employers who have unintentionally misclassified workers should be given the incentive to come into compliance. Therefore, our legislation offers a one-year amnesty to employers who have misclassified workers on the basis of a good faith interpretation of common law or of Section 503. This provision removes the devastating possibility of large assessments for back taxes, interest and penalties and insures compliance in the future.

Fourth, misclassification can have a devastating effect on the unsuspecting worker. As a contractor, he or she may receive a higher take-home pay and may be allowed to deduct more business expenses from income taxes. But the loss of financial benefits and of the many protections which are provided to employees can be catastrophic in cases of illness, unemployment and retirement. For example, there is no unemployment compensation for the independent contractor to fall back on between jobs. Health insurance is an individual responsibility and is usually far more costly than an employer's group policy. In the case of work-related injury or illness, there is no worker's compensation available. Our legislation would require prime contractors to notify legitimate independent contractors of all their tax obligations and other statutory rights and protections.

Madam Chairwoman, our investigation found that the economic incentives for businesses to misclassify workers as independent contractors are huge. An employer who misclassifies a worker as an independent contractor escapes many obligations, including paying social security taxes, unemployment taxes and workers compensation insurance, withholding income taxes and providing benefits such as vacation, sick and family leave, health and life insurance, pensions, etc. Most employers are honest, but the law abiding employer is put at a serious disadvantage since he or she cannot compete on a level playing field with those who illegally cut their labor costs. Law abiding employers will not be able to compete fairly until we provide more clear, objective standards by which businesses and the government can determine whether an individual is an employee or an independent contractor.

Lastly, Madam Chairwoman and members of the Committee, billions of dollars in federal and state tax revenues are being lost as a result of the intentional misclassification of workers. This is one of the few remaining areas where we can help balance the federal budget deficit without further cutting government services or levying new taxes. A recent Coopers and Lybrand study found that at least 35 billion dollars in legitimate tax revenue over the next 9 years will be lost by the federal government due to the misclassification of employees. At a time when critical services are on the chopping block, we can no longer allow this waste and abuse to continue. We must take steps to curb the continued misclassification of employees.

STATEMENT OF
REP. JAN MEYERS (R-KS)
CHAIR
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

JANUARY 19, 1995

"INDEPENDENT CONTRACTOR STATUS"

Our hearing this afternoon is the third in our series of hearings devoted to Tax Policy and Small Business. This afternoon we will focus on problems associated with the classification of workers by the Internal Revenue Service (IRS).

The tax consequences for worker classification are of paramount importance to business owners and workers alike. Often, the Internal Revenue Service (IRS) has sought to reclassify many bona fide independent contractors as employees. By doing so the IRS can often assess small business owners for back withholding taxes for each "employee" misclassified -- even when that "employee" has already paid self-employment and income taxes. Additionally, the IRS can add large penalties to these back taxes.

In response to the intensity with which the IRS had pursued independent contractor audits, Congress dealt with the independent contractor issue in 1978 and again in the early 1980's. Both times, Congress found the independent contractor issue extremely divisive and complicated.

The most difficult problem with independent contractor status is the lack of a clear definition. While the law passed in 1978 provided businesses with some safe harbors for determining who was an independent contractor, this area remains flawed. For example, the IRS has applied no less than 20 common law guidelines (vintage 1935) to determine employment classification. Moreover, these factors have often been applied subjectively and inconsistently in the field.

The IRS and the small business community have a mutual interest in clarifying this issue. The IRS should be encouraged to adopt consistent and reasonable standards in classifying workers.

Our hearing this afternoon will look at a broad range of views on how to best classify workers.

STATEMENT OF THE HONORABLE KWEISI MFUME

ON THE STATUS OF INDEPENDENT CONTRACTORS

January 19, 1995

Thank you, Madam Chair, for this opportunity to hear testimony and to comment on the issue of the definition of an "independent contractor." I especially appreciate the fact that you have given this issue the attention of a hearing.

As we are all aware, the question of how one defines an "independent contractor" has been a point of frustration for both the Internal Revenue Service as well as employers. Both feel, rightly so, that the ambiguity of the definition leaves them open to potential abuse and a loss of income. It is my understanding that both the IRS and the employers are eager to have the issue clarified, although I suspect that if asked they might offer slightly different solutions.

It is my understanding that the latest figures from the IRS indicate that as a result of underreporting by the self-employed, including independent contractors, the U.S. Treasury lost as much as $20.3 billion in 1992. This number is astounding, and it makes it all the more clear that we need to correct this problem.

The current system is also unfair to employers, as the ambiguities contained in and subjective nature of the law can leave many people, especially small business people with limited accounting resources, open to numerous penalties if they inadvertently misrepresent an employee as an independent contractor.

So it is clear that it is our fiscal responsibility, as well as our responsibility to our constituents who are employers, to address this issue. It is my sincere hope that as a result of this and any subsequent hearings we will be able to work with employers, employees, and the Department of Treasury to clarify the definition of an "independent contractor" to everyone's satisfaction. Such an agreement will, hopefully, make employers more comfortable and make abuse more difficult, thus bringing more money into the federal treasury.

Madam Chair, colleagues, I look forward to working with you to try to resolve this problem to the satisfaction of all concerned. I thank you again for holding this hearing and for taking a lead on this matter.

STATEMENT OF CONGRESSMAN CHRISTOPHER SHAYS
COMMITTEE ON SMALL BUSINESS

HEARING ON INDEPENDENT CONTRACTOR STATUS
January 19, 1994

Mr. Chairman, thank you for holding this important hearing on the status of independent contractors. I appreciate this opportunity to testify about the need for guidelines that specifically determine the employment classification of workers.

First, I would like to acknowledge the need to protect the rights of contractors who are truly independent and self-employed -- our nation's spirited entrepreneurs who are hard working and conscientious.

When employees are improperly classified it hurts the worker, who does not receive the benefits to which he or she is entitled; it hurts the honest employer, who loses bids to competitors who are able to illegally cut their labor costs; and finally, it hurts the government, which loses billions of dollars in tax revenues.

The real disadvantage to an employee's independent status is discovered when crisis strikes. The New York State Unemployment Commissioner told me how some employees do not know they are being treated as independent contractors and only discover this fact when they lose their jobs. They are shocked to learn that they are not eligible for benefits and their only recourse is to engage in a legal battle with their former employer.

An incident occurred in my own district where a worker was severely injured on a construction job. According to the information we received, the individual was misclassified as an independent contractor and neither the general contractor or subcontractor had workers' compensation insurance. Following the accident the Occupational Safety and Health Administration (OSHA) determined his employment status based solely on the word of his employer.

My concern is with employers who abuse the system -- those with greedy motives who misclassify their employees to undercut their competitors and avoid paying benefits that are required under law. An example of how businesses in construction have been able to take advantage of loopholes is by placing a handful of employees legitimately on the payroll so that in the event an uncovered worker is injured on the job, they can use the covered employee's name and compensation benefits.

It is estimated that by misclassifying employees, contractors in the construction industry can cut their labor costs by as much as 25 percent by failing to pay federal and state unemployment insurance, workers' compensation and Social Security taxes. This puts honest employers at a significant disadvantage when bidding for jobs as well.

And with hard economic times, with contractors desperate to win jobs, there is an even greater incentive to misclassify as a means to gain business and cut labor costs. This pattern will likely continue until a definitive rule is formed that differentiates between an employee and independent contractor.

The law-abiding employer is also hurt by misclassification since he cannot compete on a level playing field with those who illegally cut labor costs.

Another employer from my state told me how he lost a $3.5 million contract to a low bidder who hired all 50 employees as subcontractors. As a result, the state and the federal government failed to receive any taxes, unemployment or workers compensation payments.

According to the 1989 GAO report, the federal government lost $1.6 billion in tax revenues in 1984 alone because of misclassification of employees.

The costs, however, are probably even greater because when employers fail to pay unemployment benefits or to provide health care insurance, the burden of providing coverage for the uninsured falls on honest employers and the taxpayer.

After listening to these claims, Congressman Lantos and I concluded it was imperative we introduce legislation to try to put a stop to these abuses.

Our bill, H.R. 510, would provide amnesty for one year from back taxes and penalties to employers who in "good faith" misclassified their employees. These employees would have to prove they filed all the required tax forms, including 1099s, and they would have to pledge that they would reclassify their workers for the future. Moreover, we would encourage the IRS to maintain a "watch list" of these employers to ensure they continue to classify correctly.

Our intent in offering this one-year amnesty is to give employers who feel they have unintentionally misclassified their employees the opportunity to come into compliance. We believe there are many honest employers out there who would take advantage of the opportunity to set the record straight. We do not feel, however, those who willfully misclassified for financial gain and failed to file forms with the IRS should be afforded this protection.

Second, our bill would eliminate the "prior audit" safe haven under Section 530, which allows employers to continue to misclassify employees solely because they were previously audited by the IRS.

We strongly feel this protection should be eliminated. It makes little sense to us to continue to allow the wrongful classification of employees just because the company received a previous audit, which may have had nothing to do with the issue of misclassification.

Third, our bill would require the states to follow the Federal definition of employee for the purposes of unemployment compensation. We feel this provision would help clarify a great deal of confusion between differing federal and state statutes and interpretations.

Fourth, if workers are legitimately independent contractors, our legislation would require that prime contractors notify them of all their tax obligations as well as their statutory rights and protections as subcontractors.

If we are going to address the damages caused by misclassification, Congress needs to eliminate restrictions on the ability of the Internal Revenue Service to draft regulations and rulings on the employment status of workers for tax purposes. If it is true that a large part of the misclassification problem is due to a lack of understanding of the laws, it strikes me that clearer rulings and definitions would help the problem immensely.

We must also eliminate the Section 530 protections that allow misclassification to continue. Because of Section 530, employers are allowed to continue to misclassify workers if they can demonstrate they have had a reasonable basis for classifying employees as independent contractors in the past. This includes past IRS audits, an established, long-standing recognized industry practice or an IRS ruling or judicial precedent. Because of Section 530 the IRS is prevented from effectively enforcing the laws and dealing with the misclassification problem.

Lastly, I want to emphasize the need for better enforcement by the IRS. While it may cost additional funds to empower the IRS to investigate and audit independent contractors who are failing to report income and contractors who are intentionally misclassifying.

Mr. Chairman, thank you for allowing me to testify on this important issue.

Public Testimony

On

MISCLASSIFICATION OF EMPLOYEES AS INDEPENDENT CONTRACTORS

Before the

COMMITTEE ON SMALL BUSINESS

of the

U.S. HOUSE OF REPRESENTATIVES

January 19, 1995

Presented by: Mr. Ronald Baker, CBSE
Mr. Brickford Faucette, CBSE

Good afternoon, Madame Chairwoman and members of the committee. My name is Ronald Baker, CBSE, co-founder of BGM Industries, Kansas City, Missouri. It is my pleasure to appear before you today not only as a small businessman concerned about the future of my company but as President of the Building Service Contractors Association International.

Accompanying me this afternoon is Mr. Brickford Faucette, CBSE, of Perimeter Maintenance Corporation of Atlanta, Georgia. Mr. Faucette is founder and owner of his company of 500 employees.

BSCAI is an association of companies predominantly involved in the contracting of janitorial services and is incorporated as a 501(c)(6) trade association. We currently have approximately 3,000 members throughout the United States and the world. Our headquarters are located at 10201 Lee Highway, Suite 225, Fairfax, Virginia 22030.

The issue before your committee represents one of the most pervasive problems in the marketplace today, the practice of employers misclassifying their workers as independent contractors.

In the building service contracting industry this practice is most often referred to as illegal subcontracting. As a result, the building service contracting industry, along with other service and construction industries, have been operating on an unlevel playing field for years. This "silent killer" is affecting an industry that, according to Department of Labor projections, by the

year 2000 will create 555,000 new jobs and make up a total work force of 3.45 million janitors.

Congressional hearings have documented that employers who exploit the ambiguities in the employment tax laws by intentionally misclassifying workers or evading enforcement efforts under the protection of Section 530 safe harbors can severely impact the law abiding taxpayer, deprive federal and state governments of employment tax revenues, as well as the benefits that are rightfully due each and every worker in the nation.

During Congressional hearings last year, this issue came to the forefront of the health care debate and even raised greater concerns among law-abiding building service contractors. As result of the efforts of the Coalition for Fair Worker Classification, of which BSCAI has been an active participant, it has been documented by the prestigious firm of Coopers and Lybrand that the intentional classification of employees as independent contractors will cost the federal government $35 billion dollars over the next nine years.

The study, a copy of which has been provided as Addendum A and which we respectfully submit for the record, confirms that in the service sector alone over 2.1 million workers will be misclassified by 2005, representing a 60 percent increase over a 21-year period.

While legitimate independent contractors are an important element of the American free enterprise system, taking advantage of poorly conceived tax policy goes against the competitive spirit that is the foundation of American small business.

I wish to introduce at this time Brickford Faucette, CBSE, of Atlanta, Georgia. His firm has provided janitorial services since 1985 to commercial and institutional clients in the Atlanta metropolitan area. Mr. Faucette also serves as Chairman of our association's Government Affairs Committee.

Madame Chairwoman and committee members, it is my privilege today to testify on behalf of not only my company of 500 employees but also the thousands of building service contractors across the nation who continue to suffer the consequences of an unlevel playing field.

As previously noted, our association has been an active participant in congressional hearings on this issue. As recently as last year we testified before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means. As a result of these hearings we were requested to submit documentation representing the plight of building service contractors across the country. I would respectfully request that documents (see Addendum B) provided by BSCAI members Maintenance Inc. of Dallas, Texas and Kern Commercial Cleaning of Bakersfield, California to the Subcommittee on Select Revenues last September be submitted for the record as personal documentation of the growing problem of misclassification of workers in the building service contracting industry.

With the Chairwoman's permission, I would like to briefly discuss the current situation my company is experiencing in Atlanta as well as others throughout the United States regarding misclassification of workers as independent contractors.

Terminology. The misclassification issue here in the Congress and at the IRS is discussed in the context of classifying workers as "employees" or "independent contractors." In the building services industry, we refer to this issue as the "illegal subcontracting" problem. While the terminology is somewhat different, the issue is the same.

How Companies In Our Industry Do Business. Business in my company and our industry is generally done on a contract bid system. Commercial building owners or commercial tenants solicit bids from potential cleaning companies. Interested companies in that market submit bids. The owner or tenant then accepts the bid which best meets his or her needs.

The Misclassification Problem In Our Industry. Based on our knowledge and experience of the industry, BSCAI believes the typical cleaning company in the building services industry treats its workers as employees, not independent contractors. This is the "prevailing industry practice," certainly when viewed on a national basis. We also believe this to be the case with respect to nearly all individual local markets. We have submitted correspondence to the IRS on this point. It is attached and marked Addendum C.

The IRS uses 20 common law factors to determine whether a worker is an "employee" or an "independent contractor." We believe that under any reasonable interpretation of this test, the workers in our industry are "employees."

The misclassification problem occurs in our industry when a firm bidding for a cleaning contract

does so based on "subcontracting out" the actual cleaning work to "independent contractors" (the actual workers who do the cleaning).

A firm bidding on this basis has an obvious competitive advantage over a firm bidding based on classifying its workers as employees. The firm supposedly "subcontracting out" the work does not have to concern itself with various labor burden costs, such as federal FICA, FUTA, state SUTA, worker's compensation and general liability insurance costs. The "subcontracting" firm also does not have the administrative costs associated with tax compliance for employees. This package of costs vary from state to state, but is generally in the range of twenty to thirty percent of the contract price.

The problem appears to be growing worse as more and more local markets such as mine are affected. In some cases such as in Atlanta, Houston and Dallas, the "subcontracting out" practice has become so prevalent that it may -- absent action by Congress and/or the IRS -- become the "de facto" prevailing industry practice in those markets.

Protecting the Workers. Previous Congressional testimony has addressed in detail the harm done to the workers involved in misclassification. We think the harm is fairly obvious.

While a worker so misclassified may gain the temporary advantage of not having his or her wages subject to withholding, that worker loses a number of benefits and protections, such as worker's compensation, unemployment insurance protection, employer contributions to his or

her social security, etc.

I would also add that the workers involved, at least in our industry, are often recent immigrants to the United States who are even more subject to potential abuse because of their unfamiliarity with the language and the law.

Clearly, workers lose out when their status is misclassified by an employer.

The federal, state and local governments, I would add, also lose substantial amounts of tax revenue.

The Impact of the Safe Harbor Provisions. We believe it is not a coincidence that our problems with illegal subcontracting began around 1978 when Congress added the safe harbor provisions to the tax code. While we can't prove this, I think you will agree the coincidence is striking.

The prior tax audit provision in particular has proven to be a problem. It is our understanding that a company which has undergone a prior audit is then protected for the indefinite future from IRS inquiry concerning the classification of that company's workers. We understand this is true even if the audit was for something such as income taxes and not specifically directed to employment taxes.

We believe this provision "rewards" a company misclassifying workers. It is unfair to

competing firms. It is bad tax policy. It harms workers. It harms the federal, state and local government through lost tax revenue.

Perhaps the biggest negative of Congress' passage of the safe harbor provisions was the very strong signal it sent to the IRS to tread softly in this area. Action by Congress in the 1980s was insufficient to undo the harm done in 1978.

We do our workers no favor if we rob them, through misclassification as independent contractors, of worker's compensation, unemployment insurance, disability insurance, protection under the Fair Labor Standards Act, the Occupational Safety and Health Act, the American with Disabilities Act, the Family Leave and Medical Act of 1993 and protection through the Equal Employment Opportunity Commission which have been erected by the federal and state government over the past half century.

To Summarize the Problem in Our Industry. Workers in our industry under applicable common law traditionally are "employees."

The prevailing practice in our industry is to treat workers as employees, not independent contractors.

Misclassification creates a competitive problem. Companies bidding against each other have different cost structures because one of those companies is misclassifying its workers as

"independent contractors" rather than "employees.

I believe this to be unfair, contrary to current applicable law, and harmful to the workers themselves.

I believe strongly this is a matter of fundamental fairness. From my perspective and that of our membership, companies acting responsibly and classifying workers -- correctly -- as employees are put at a competitive disadvantage by firms incorrectly classifying their workers as "independent contractors."

Recommendations. Congress should pass legislation that clarifies with legislative and regulatory oversight the resolve of a long standing issue that to date has handicapped the entrepreneurial spirit of the small business owner, deprived employees of benefits due them under the law, and robbed the federal and state governments of much needed revenues.

While BSCAI's membership has not had the opportunity to review and evaluate the details of H.R. 510, we are committed to any efforts that would create a fair and competitive environment for the treatment of employees and independent contractors.

We have in the past and will continue to support legislation that would clarify the ambiguities of current employment tax law as it relates to the definition of employees. In particular, we support elimination of the prior audit "safe harbor" provisions under current law as we believe

this has been the most abused aspect of the "safe harbor" provisions.

We also support vigorous enforcement and audit action by the Internal Revenue Service to ensure proper classification of workers as employees when appropriate under applicable law. We feel that an amnesty program for employers who have misclassified, but relied on "prior audit" protection of Section 530, would be a positive and useful step in helping correct current cases of misclassification.

By clarifying the employment tax laws Congress has the potential to generate billions of dollars in revenues at a time when it is so desperately needed. This Congress should not expect law-abiding companies to shoulder increasing financial responsibilities while competitors providing similar services are allowed to evade these responsibilities.

There are few who argue the important role that American small businesses will play in the future growth and stability of our economy. Too often our efforts to create economic growth and new jobs are interrupted by inequities of our own creation, in this case, ambiguities in the employment tax laws. In the interest of securing not only our nation's economic best interests but the that of American small business, it is our hope that this Committee and Congress will act with expediency and commitment in resolving this long standing issue.

On behalf of my company and its employees and our association's President, Ron Baker, I want to thank the members of the Subcommittee for the opportunity to participate in these hearings

and applaud the Committee's Chairwoman for recognizing the importance addressing this important issue in the 104th Congress.

We would be most happy to answer any questions which the members or committee staff may wish to ask.

Thank you.

PROJECTION OF THE LOSS IN FEDERAL TAX REVENUES DUE TO MISCLASSIFICATION OF WORKERS

Prepared for

COALITION FOR
FAIR WORKER CLASSIFICATION

by

COOPERS & LYBRAND

July 1994

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1. Introduction

The Coalition for Fair Worker Classification[1] has employed Coopers & Lybrand to analyze and report on the effect that worker misclassification has on federal tax revenues. This report uses information from the Internal Revenue Service (IRS) and the U.S. Bureau of Labor Statistics (BLS) in an attempt to quantify the extent of employee misclassification and the corresponding lost federal revenues under present law. Trends in misclassified workers, and in self-employed workers are also presented. Revenue estimates for two proposals are provided: (1) repeal of Internal Revenue Code Section 530 only, and (2) elimination of misclassification for all independent contractors not affected by §530.

Title VII Subtitle C of the *Health Security Act* (H.R. 3600) would repeal §530 and incorporate a revised version of the provision directly into the Internal Revenue Code. Under the revision, the IRS would be instructed to issue regulations clarifying the definition of an employee. The prior-audit safe harbors also would no longer apply if the treatment were inconsistent with published IRS regulations and the industry-practices safe harbor would cease to be applicable. The Coalition is developing a set of guidelines that would limit IRS rule-making discretion under the Health Security Act.

The report is divided into seven sections, including this introduction. Other sections include in order: Executive Summary, Background, Incentives for Misclassification, Summary of Previous Government Studies, Revenue Estimate, and Conclusion.

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[1] Members of the Coalition include: A Chauffeured Limousines and Sedans, Auto Driveaway Company, Building Services Contractors Association, International, Harry L. Thomas, Inc., Home Health Services and Staffing Association, Institute of the Ironworking Industry, International Brotherhood of Painters and Allied Trades/AFL-CIO, International Brotherhood of Teamsters, Metropolitan Limousine, Naperville Chauffeuring, Ltd., National Alliance for Fair Contracting, National Association of Temporary Services, National Technical Services Association, Pro Courier and Messenger, Service Employees International Union, AFL-CIO, CLC., United Brotherhood of Carpenters and Joiners of America/AFL-CIO, U.S. Cargo and Courier Services.

II. Executive Summary

Proposals to finance health care reform with payroll-based levies have caused increased concern among businesses that face competition from firms which misclassify their employees as independent contractors as well as with groups concerned with employee interests and rights. Under current law, with only certain exceptions, employers may treat their workers as independent contractors if they satisfy any one of the three safe harbors: (1) judicial precedent; (2) a past IRS audit which did not result in a reclassification of employees — even if unrelated to employment taxes; or (3) reliance on long-standing industry practices. Businesses that comply with payroll tax law fear that any increase in payroll taxes unaccompanied by a restriction of these safe harbors, will induce greater tax avoidance by many firms, and that the problem will continue unchecked. Groups concerned with worker issues fear a further erosion of employee benefits.

Government agencies — primarily the IRS and the General Accounting Office — have documented the extent of such tax avoidance in a series of studies over the past 15 years. This study, by integrating IRS research and BLS data, presents additional information on the number of misclassified workers and on the associated federal tax revenues lost due to misclassification.

We estimate that the number of misclassified non-agricultural, non-mining workers will have grown from 3.3 million in 1984 to 4.1 million this year and over 5 million by the year 2005. By far the largest number of misclassified workers are in the services sector. We estimate there will be over 2.1 million service workers misclassified by 2005. These estimates are based in part on our projections that the number of self-employed persons[2] will exceed 9 million this year and exceed 11 million by 2005. The fastest growing segment of self-employed persons are engaged in the construction industry. By 2005, self-employed engaged in construction are expected to total 2.3 million, about 27 percent of the construction workforce. By contrast, self-employed persons engaged in retail and wholesale trade are expected to decline to 1.5 million by 2005, representing about 4 percent of the workforce engaged in that segment of the economy.

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[2] While "self-employed" and "independent contractors," as used in this report, have similar meanings, they are not intended to be interchangeable terms.

Projection of the Loss in Federal Tax Revenues due to Misclassification of Workers

We estimate that in calendar year 1996, there will be a $3.3 billion loss in federal revenues due to the misclassification of workers, of which $0.5 billion is protected by §530. If adequate resources were brought to bear, effective January 1, 1996, in order to ensure proper compliance, our projections show that reclassification of §530 workers (with repeal effective January 1, 1996) would raise $4.9 billion over the nine-year period, fiscal years 1996-2004. Reclassification of all misclassified workers would raise an additional $29.9 billion over this same period, for a total increase in federal tax receipts of $34.7 billion.

Our projections do not take into consideration the likely revenue impact of an additional payroll tax which has been included in a number of the current health care reform proposals to fund universal health care coverage. Such increases will certainly induce additional employers to consider a shift to independent contractor status in order to avoid the proposed tax and to qualify for the subsidies that are likely to be offered to uninsured workers. The resulting changes in employment status will likely cause further increases in the revenues lost from misclassification.

III. Background

Under current law, the IRS generally relies on a set of 20 factors in order to determine whether for tax purposes an individual is to be treated as an employee or as an independent contractor.[2] Irrespective of this outcome, §530 of the *Revenue Act of 1978* restricts reclassification of workers by the IRS in the event that the employer satisfies any one of the following three safe harbors: (1) the employer bases his treatment on judicial precedent, rulings or similar information; (2) a past IRS audit — even if the audit was unrelated to employment taxes — did not result in an assessment related to employee misclassification; (3) employer treatment is based on long-standing recognized practices within the industry.[3] Section 530 also bars the IRS from publishing regulations which alter the current rules. An important exception to §530 occurs in instances where an employer reclassifies as independent contractors workers who held similar positions as employees after 1977.

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[2] According to the Internal Revenue Manual, workers are regarded as employees under the following circumstances:

- They must comply with employer instructions about work.
- They receive training from/at the direction of the employer.
- They provide services that are integral to the business.
- They provide services that must be rendered personally.
- They hire/supervise/pay assistants for the employer.
- They have a continuing working relationship with the employer.
- They must follow set hours of the work.
- They work full-time for the employer.
- They do their work on the employer's premises.
- They must do their work in the sequence set by the employer.
- They must submit regular reports to the employer.
- They receive payments of regular amounts at set intervals.
- They receive payments of business/travel expenses.
- They rely on the employer to furnish tools and materials.
- They lack a major investment in facilities used to perform the service.
- They cannot make a profit/loss from their services.
- They work for one employer at a time.
- They do not offer their services to the general public.
- They can be fired by the employer.
- They may quit at any time without incurring liability.

[3] Section 530 was subsequently extended several times, most recently under the *Tax Equity and Fiscal Responsibility Act of 1982*. Section 1706 of the *Tax Reform Act of 1986*, however, cut back the application of §530 for three-party arrangements involving technical service workers, such as engineers, designers, drafters, computer programmers and related professions.

IV. Incentives for Misclassification

In its discussion of the motivation for Congressional enactment of §1706 which concerns technical service workers, the Treasury stated: "Section 530 affects different taxpayers differently, depending on whether they satisfy the conditions for relief contained therein. In particular, some taxpayers that have consistently misclassified their employees as independent contractors are entitled to relief under §530, while other taxpayers in the same industry (that, for example, have taken more conservative positions on classification issues) are not, because they cannot satisfy the consistency requirements of the Section."[4] A fundamental tenet of federal tax policy is that the tax code should be neutral with regard to taxpayer behavior — that is, tax considerations should not motivate employers and employees to consider reclassifying workers as independent contractors in order to minimize tax liabilities.

Both employers and employees may benefit from misclassification for a variety of reasons, some of which may be non-tax related.[5] From a tax perspective, workers for whom the tax-free receipt of fringe benefits exceeds the value of deducting employment-related expenses will prefer to be treated as employees; for those with significant expenses and less need for such fringes, independent contractor status will be preferable. Employees may only deduct itemized business-related expenses to the extent that such expenses exceed two percent of adjusted gross income. By contrast, independent contractors may deduct in full all such expenses.

Similarly, employers who are able to furnish fringe benefits at a lower price because of greater market power may opt to treat workers as employees rather than to pay them higher wages as independent contractors. Many employers, however, may escape certain tax obligations and onerous work place requirements by misclassifying workers as independent

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[4] See *Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986*, U.S. Treasury Department, March 1991, pp. 32-33.

[5] For a detailed discussion of these issues, see Appendix A ("Differences in Treatment of Employees and Independent Contractors — Detailed Analysis") of *Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986.*

contractors.[6] Independent contractors, for example, are not subject to unemployment insurance and workers' compensation. In its technical services personnel report, the Treasury assumed that these taxes totaled 1.55 percent of overall salary.[7]

Independent contractors also benefit from the ability to retain earnings for a period of time before remitting taxes to the government. While a portion of employees' salaries are withheld when they are paid in each period, independent contractors must pay estimated taxes in quarterly installments — April 15, June 15, September 15, and January 15.[8] So-called "employers" of independent contractors are also able to avoid other statutory obligations imposed on employers, such as unemployment compensation benefits, overtime, and regulations imposed by the Occupational Safety and Health Administration and Employee Retirement Income Security Act.

Under the Administration's health reform plan and a number of other proposals, an additional incentive to treat workers as independent contractors would be the health care premium collected to finance the plan. In some instances, a firm could claim that a worker is an independent contractor while the worker claims to be an employee; neither would pay the employer premium. Although similar incentives exist at present, the consequences would be considerably greater under health care reform. Because the option of treating workers as independent contractors is limited to those who may claim exemption under the §530 safe

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[6] The primary employment taxes, Social Security and Medicare, at one time — prior to 1984 — treated self-employed workers more favorably. The self-employed rate was significantly lower than the combined rate paid for employees, but based on similar earnings histories, the benefits received were the same despite the smaller contributions of the self-employed. At present, employers and employees each pay 7.65 percent FICA tax (15.3 combined) on the first $60,600 of wages; self-employed individuals pay an equivalent 15.3 percent in SECA taxes. As of January 1994, the Medicare portion of the tax applies to all wages.

[7] Unemployment insurance is levied at a rate of 2.8 percent on the first $7,000 of employee wages (Source: *Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986*, U.S. Treasury Department, March 1991, pg. 65). Thus, the tax impact for low-wage workers would be somewhat larger.

[8] Annual wages are reported for employees on Forms W-2 and for independent contractors generally on Forms 1099-MISC. While W-2 information must be submitted together with the annual tax return, there is no similar requirement that 1099s be submitted with contractors' returns.

harbors, many employers complying with the law may be further disadvantaged under the proposed plan unless changes are made to the safe harbors.[9]

Although all types of misclassification which involve public policies should be matters of concern, the treatment of employees as independent contractors is of still greater concern because the U.S. tax system contains relatively few controls to ensure compliance. Past studies by the IRS, for example, have found that independent contractors are more likely to underreport income and/or overstate expenses. In instances where workers receive comparable compensation in the form of non-taxable fringe benefits, independent contractors may pay more in Social Security taxes, since they must pay both the employer and employee portion of the payroll tax.[10]

[9] The Administration's proposal would revise and codify §530 and also permit the IRS to issue guidance for determining who is an employee for employment tax and income tax purposes, and health care coverage. The IRS will be required to give substantial weight to common law practices in defining employment status. The plan also would repeal the "industry-practice" safe harbor once the IRS issued regulations and would restrict the "prior audit" safe harbor to situations in which a concluded IRS audit examined employment status and found it to be acceptable.

[10] Contractors are permitted an offset against their individual income taxes — similar to the tax treatment for employers — which reduces their effective payroll tax rate.

V. Summary of Previous Government Studies

The Treasury report on technical services personnel reviews findings from previous government studies that were conducted concerning the misclassification of workers. The principal conclusions from these studies and two other relevant government analyses — one performed by the IRS and another prepared by the U.S. General Accounting Office (GAO) — are summarized below.

SVC-1. During 1986 and 1987, the IRS Strategic Initiative on Withholding Noncompliance (SVC-1) surveyed a sample of roughly 3,000 employers. Those included in the sample were selected so as to represent 5 million employers stratified according to industry and by size of firm within industry. Based on data from the 1984 tax year, the percentage of employers misclassifying at least some of their workers as independent contractors was determined. SVC-1 results are reproduced as Table 1.

Table 1: Percentage of Employers with Some Misclassified Workers, by Industry

Industry	Percent of Total
Agriculture	16.7%
Mining	18.6%
Construction	19.8%
Manufacturing	15.8%
Transportation	11.2%
Trade	9.6%
Finance, Insurance, Real Estate	19.3%
Services	15.4%
Government	9.6%
Not otherwise classified	12.6%
Total	13.4%

Source: *Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986*, U.S. Treasury Department, March 1991, Table 5-1, p. 49.

On average, 13 percent of employers were found to misclassify at least some workers. In terms of numbers of employees, only about two percent were determined to have been misclassified. For certain portions of the construction industry and for the service sector, however, the shares that were misclassified were nearly double — 3½ percent. These two sectors accounted for more than 25 percent of all employers and employees involved in misclassification, but slightly less in terms of compensation — workers in these sectors tended to be paid less than other misclassified workers.

The majority of employers who misclassified workers tended to be small firms. When grouped into two categories — firms with fewer than 100 workers and those with 100 or more — small companies were found to employ only about 40 percent of the workers yet were responsible for nearly 90 percent of those misclassified. Slightly more than 90 percent of the compensation on which employment taxes were incorrectly paid also was attributable to this group.[11]

Separately, a survey of 3,000 of the misclassified workers was conducted. The 1984 SVC-1 Employee Survey identified roughly 2,400 employees from this sample for whom Forms 1099 were filed. Overall, 77 percent of Form 1099 income was reported by misclassified workers. In instances where no Form 1099 was filed, less than 30 percent of compensation was declared, however.

TCMP. The IRS 1985 Tax Compliance Measurement Program (TCMP) compared reported wages and selected Form 1040 Schedule C tax return information (e.g., profits and deductions) with corrected amounts after review. The IRS found that independent contractors tended to underreport taxable income by roughly 20 percent; by contrast, wage and salary income was reported nearly in full by employees. About one-third of the shortfall from independent contractors appears due to overstatement of deductions which, according to the Treasury, may have been addressed in part by subsequent legislation.

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[11] The IRS also determined that an additional ten percent of workers were employed by firms that fell within the §530 safe harbor. Approximately 40 percent worked for larger companies. Nearly all of the employers qualifying under §530 — 68 thousand of 70 thousand — were protected by the industry-practice and prior audit safe harbors. See *Strategic Initiative on Withholding Noncompliance Employer Survey: Report of Findings*, Research Division, Internal Revenue Service, June 1989.

Taken in combination with the SVC-1 survey findings, the TCMP results suggest that taxpayer compliance is lower among independent contractors and still less among workers misclassified as independent contractors (who do not receive Forms 1099).

GAO 1989 Study. The GAO matched 1985 tax year Forms 1099 information returns submitted by employers with income tax returns filed by independent contractors in order to identify workers who received more than $10,000 from a single employer. Of the 32,000 employers and nearly 200,000 individuals who were so identified, 408 employers were randomly selected. From this group, the GAO uncovered evidence of misclassification by 157 employers — 38 percent — of at least some employees.[12]

1979 Employee/Independent Contractor Compliance Study. An earlier study conducted by the IRS examined payment patterns for a sample of 2,600 employers and 7,100 employees initially treated as independent contractors who were reclassified. For the roughly 5,000 employees for whom information could be collected and tabulated, the IRS determined the extent to which employer payments were reported on the workers' income tax returns.[13] The results, classified by the employer's industry and the individual's occupation, indicated the following:

- Overall, 47 percent of the workers treated as independent contractors did not report any compensation (see Table 2).
- Income tax noncompliance, however, was only 24 percent. This lower figure was primarily due to the higher compliance rates among those who received larger payments and for those with higher adjusted gross incomes. Most workers tended either to report all of their income or none of it: 48 percent receiving 70 percent of the total payments reported all of their compensation; 47 percent with 20-25 percent of total payments reported none.

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[12] See *Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers*, U.S. General Accounting Office, September 1989, Report GGD 89-107.

[13] The findings described below are summarized from *Description of Proposals Relating to Independent Contractors Scheduled for a Hearing*, Joint Committee on Taxation report JCS-31-79, July 13, 1979.

- Variation in compliance among industries and occupations could be traced largely to the distribution of the sizes of the payments and to the distribution of incomes within industries and occupations.

These findings were considered to be conservative because these did not take into account the totally non-compliant workers for whom no information could be collected — about one-fifth of the sample. Moreover, the figures reported in Table 2 do not include amounts the IRS determined were owed for Social Security taxes, which at the time were considerably greater for employers and employees on a combined basis than for independent contractors.[14]

[14] In its survey, the IRS found that noncompliance for Social Security tax purposes was greater than for income taxes. We do not report the Social Security figures, however, because the likely source of the greater noncompliance at the time — the difference between the self-employed payroll rate and the combined employer-employee rate — has been eliminated. If the payroll tax burdens employees and independent contractors face under current federal health care reform proposals are not equalized, this source of non-compliance could reemerge.

Table 2: IRS Employee/Independent Contractor Compliance Survey: Individual Income Tax Compliance Rates by Industry

Industry	Percent of Compensation Reported	Percent of Employees Who Were		
		Fully Compliant	Partially Compliant	Non-Compliant
Real Estate	90%	75%	5%	20%
Insurance	98%	90%	4%	6%
Direct sales	69%	51%	6%	43%
Other Sales	74%	48%	5%	47%
Logging and timber	52%	23%	8%	69%
Franchise operations	73%	38%	10%	52%
Barber and beauty shops	90%	73%	7%	20%
Trucking	67%	41%	5%	54%
Taxicabs	44%	32%	3%	65%
Home improvement	70%	40%	5%	55%
Real estate construction	64%	31%	6%	63%
Warehousing	54%	16%	4%	80%
Eating and/or drinking places	59%	33%	8%	59%
Entertainment	78%	54%	4%	42%
Exempt organizations	98%	76%	2%	22%
Medical and health services	90%	67%	5%	28%
Consulting	76%	56%	3%	41%
Other industries*	73%	45%	4%	51%
Total	76%	48%	5%	47%

Source: "Description of Proposals Relating to Independent Contractors Scheduled for a Hearing," Joint Committee on Taxation report JCS-31-79, July 13, 1979, Table 3.

* Includes industries not separately identified, such as farming, manufacturing, janitorial service, messenger service, security service, oil exploration, legal services, nursery, market research, modeling agency, CPA review, opinion survey, snow removal, data processing, funeral home and landscaping.

Table 3 highlights the survey findings when income tax noncompliance rates were cross-classified by industry and by occupation. The compliance rates for occupations which fell below the industry-wide rates are marked in bold italics. Most often, those in bold italics corresponded to unskilled labor and clerical occupations, although other occupations also were considerably below the average in specific industries.[15]

[15] Because the 1979 IRS study did not report on the number of non-compliant individuals in particular industry-occupation combinations, it is uncertain whether the deviations from the average are statistically significant.

Table 3: IRS Employee/Independent Contractor Compliance Survey: Individual Income Tax Compliance Rates by Industry and by Occupation

Industry	Occupation										
	Manager/ Distributor	Skilled Labor	Unskilled Labor (Casual)	Unskilled Labor (Non-casual)	Driver	Sales	Professional	Clerical	Entertainer	Other	All
Real Estate	*79%*	*70%*	*65%*	*13%*		93%	*17%*	*51%*			90%
Insurance	99%			*48%*		*97%*		*71%*			98%
Direct sales	90%	*66%*	86%	*52%*	*46%*	73%	99%	*29%*	*60%*	79%	69%
Other Sales	89%	*56%*	*55%*	*34%*	*62%*	83%	*61%*	82%		*6%*	74%
Logging and timber		*41%*	*18%*	*43%*	93%						52%
Franchise operations	92%	82%	*31%*	*10%*		*48%*					73%
Barber and beauty shops		89%					*62%*		100%	99%	90%
Trucking		88%	*13%*	*38%*	68%	97%	99%				67%
Taxicabs					*44%*						44%
Home improvement		74%	*53%*	*50%*	82%			*34%*			70%
Real estate construction		67%	*25%*	*44%*	96%				100%		64%
Warehousing	71%	*38%*	*14%*								54%
Eating and/or drinking places		60%	*50%*	*44%*					67%		59%
Entertainment		97%	*61%*	88%		*60%*	91%		*71%*		78%
Exempt organizations				*80%*			99%	*57%*			98%
Medical and health services		*77%*		*15%*	*57%*	*87%*	96%	*78%*		*5%*	90%
Consulting		99%				*12%*	89%	*50%*			76%
Other industries*	99%	*69%*	*48%*	*51%*	*65%*	82%	93%	83%	89%	81%	73%
All	96%	70%	43%	49%	67%	86%	94%	75%	76%	78%	76%

Source: "Description of Proposals Relating to Independent Contractors Scheduled for a Hearing," Joint Committee on Taxation report JCS-31-79, July 13, 1979, Table 9A

* See Table 2 above for a description of the industries included

VI. Revenue Estimate

The IRS periodically produces estimates of the federal tax gap, that is, the difference between tax that is owed and that which is voluntarily paid in a given year. Some of this tax is eventually collected through audit and other compliance efforts of the IRS. Most goes uncollected because existing enforcement procedures are inadequate or the collection of such sums is deemed an inefficient use of compliance resources.

When the technical staffs of the Joint Committee on Taxation and the Treasury's Office of Tax Analysis are required to estimate increased government tax revenues that would result from proposed changes in the law or regulations affecting compliance with tax rules, they typically are skeptical regarding the efforts and abilities of the IRS to achieve significant closure of the tax gap. In part, this skepticism is linked to the fact that necessary appropriations for new compliance staff may not be forthcoming in a timely manner.

The revenue estimates included in this report assume that necessary compliance resources will be made available — through new hiring or the reallocation of existing IRS personnel — to enforce the rules. One estimate is of the revenue consequences of repealing §530, which provides certain safe harbors, and the other estimate is of the additional revenue consequences of correcting the remaining misclassifications of independent contractors. In the sense that these estimates rely upon adequate compliance efforts, they are consistent with IRS estimates of the tax gap resulting from the misclassification of independent contractors, as reported in their 1984 SVC-1 study, and, more recently, discussed by Commissioner Richardson in her April 22, 1994 letter to Congressman Steny Hoyer, Chairman of the House Appropriations Subcommittee on Treasury, Postal Service, and General Government.

The basic information underlying the 1984 report are the number of misclassified employees and corresponding misclassified compensation for all such employees as well as for those protected by §530. The data developed by the IRS for tax year 1984 are further broken down according to major industrial sector: construction, manufacturing, transportation, and so forth. The following methodology describes how our revenue estimates are derived to be consistent with the 1984 IRS data recently submitted to Chairman Hoyer. Critical assumptions are clearly identified at each step.

Civilian Employment. Total civilian employment in the U.S. is reported by the BLS. These data show employees according to the industry in which they work. The BLS has forecast the level of employment for each major industry according to three assumptions: a low trend, a moderate trend, and a high growth trend. We have based our estimates on the moderate trend. This trend shows that the annual average rate of growth in employment for the 15-year period, 1990-2005, will be 1.23 percent. By contrast, the low-trend assumption was that employment would grow an average of 0.74 percent per year and the high-trend assumption had employment growth projected at a 1.56 percent annual rate.

For the six critical sectors upon which this report focuses, the implicit annual average rates of growth in employment (other than the self-employed and unpaid family members) between 1990 and 2005 are shown in Table 4 below.

Table 4: Forecast Annual Average Rates of Employment Growth, By Selected Sectors, 1990-2005

Construction	1.11%
Manufacturing	-0.21
Transportation	0.93
Trade	1.43
FIRE*	1.26
Services (including Government)	1.86

* FIRE = Finance, insurance, and real estate.
Source: U.S. Bureau of Labor Statistics, *Monthly Labor Review*, November, 1991.

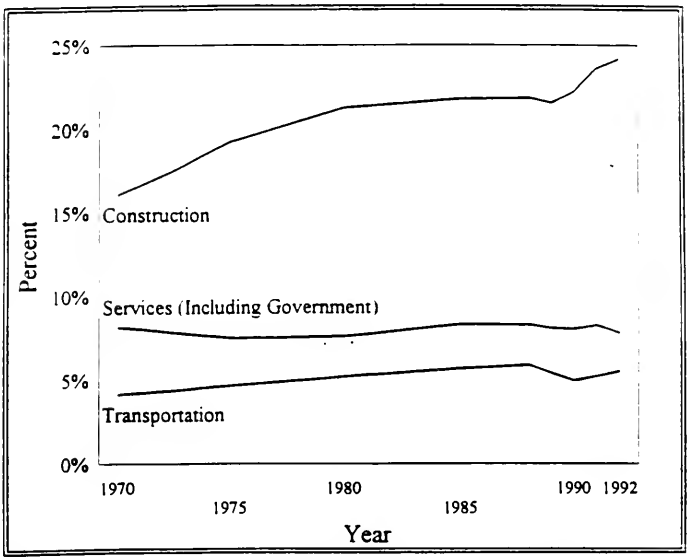
We applied derived annual rates of growth to produce projections of workers in each of the 12 years between 1992 — the latest year for which we have comparable data — and 2005, the target year for the BLS projection.

Self-employed Persons. Employees who are misclassified as independent contractors are part of a larger group of persons who are self-employed persons. The majority of these are properly classified as independent contractors. Bureau of Labor Statistics figures for 1990 reveal

that the number of self-employed persons in sectors other than agriculture grew 25 percent since 1980 and 68 percent since 1970. These averages do not tell the full story, however, since the growth of independent contractors in some sectors experienced much faster growth. For example, between 1970 and 1990 self-employed persons in finance, insurance, and real estate grew 150 percent. Next ranked construction, with a growth of 113 percent. This was followed by services (including government) at 89 percent growth. Manufacturing, transportation (including utilities and communications), and trade all grew as well, but at rates lower than the overall 68 percent growth that applied, on average, to the category of self-employed between 1970 and 1990. In order to project forward this population of self-employed persons, from which the population of misclassified independent contractors is drawn, we examined the relationship of independent contractors and employees for each major industrial sector.

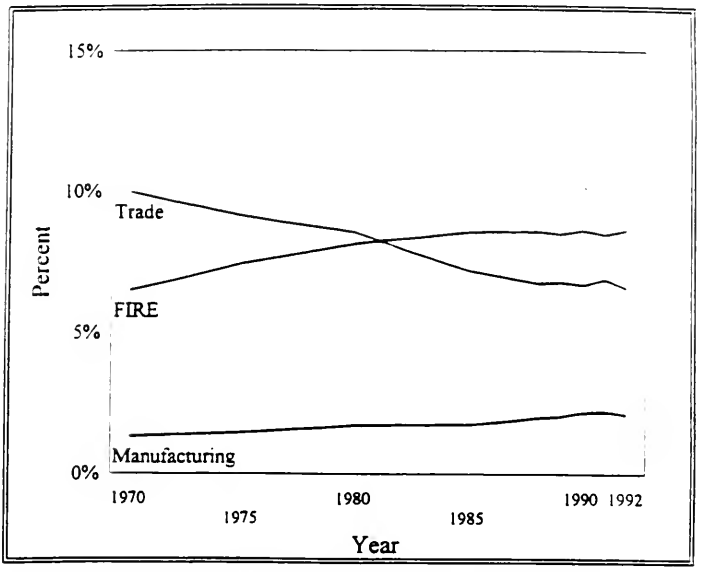
As might be expected, the fraction of workers who are independent contractors varies both by sector and over time. Charts 1a and 1b illustrates this point for those engaged in construction, trade, services, finance, transportation, and manufacturing. Of these six sectors, the one with the largest proportion of independent contractors is the construction industry (Chart 1a). In 1970, 16 percent of all construction workers claimed self-employed status. By 1992, this fraction exceeded 24 percent. The sector with the next highest concentration of independent contractors in 1970 was retail and wholesale trade, with 10 percent of the workforce claiming self-employed status (Chart 1b). By 1992, however, this fraction had fallen to about 6.5 percent. With independent contractors at 8.2 percent of the workforce, the services sector (including government) ranked third in the relative use of independent contractors in 1970 (Chart 1a). By 1992, this percentage fell too, to about 7.8 percent. As the charts show, for the remaining three sectors shown, FIRE (finance, insurance, and real estate), self-employed persons were less common. For each of these three sectors the fraction of workers who were self-employed grew over the period; however, by 1992, the fractions still remained relatively small.

Chart 1a: Self-Employed Persons as a Percent of All Workers, Construction, Services, and Transportation, Selected Years, 1970-1992



Source: Coopers & Lybrand calculations based on Bureau of Labor Statistics data.

Chart 1b: Self-Employed Persons as a Percent of All Workers, Trade, Finance, Insurance, and Real Estate, and Manufacturing, Selected Years, 1970-1992



Source: Coopers & Lybrand calculations based on Bureau of Labor Statistics data.

The percentage of workers in each industry who were reported to be self-employed between 1970 and 1992 form the basis for our projecting these fractions forward to the year 2005. The ratio of self-employed workers to total workers (i.e., self-employed workers plus employees) was separately projected for each of the six major sectors discussed above. This methodology rests on the assumption that trends over the past 22 years are good predictors of the next 13 years. Any number of "external shocks" could alter these long-term relationships. For example, mandated employer-provided health care could be expected to drive the fraction of independent contractors higher than the trend line, while increased vigilance on the part of the IRS regarding misclassified workers could drive the fraction lower.

These results were then applied to the projection of total workers derived from the BLS forecast of workers in 2005 to produce a projection of the number of self-employed persons through the year 2005. The outcome of this analysis appears in Table 5. At five-year intervals, the number of self-employed persons is shown for each of the six critical industries from 1970 through 2005. Numbers for the years 1970 through 1990 are actual figures, and the numbers for the years 1995 through 2005 are projected.

Table 5: Self-Employed Persons, Actual and Projected By Selected Sectors, 1970-2005
(In Thousands)

Sector	Year							
	1970	1975	1980	1985	1990	1995	2000	2005
	----------Actual----------					---------Projected---------		
Construction	687	839	1,173	1,301	1,463	1,578	1,896	2,272
Manufacturing	264	273	358	347	429	429	470	512
Trade	1,667	1,709	1,899	1,792	1,859	1,680	1,584	1,458
Transportation	196	223	282	315	302	362	402	446
FIRE*	254	335	458	558	635	698	793	899
Services	2,140	2,310	2,804	3,477	4,048	4,429	4,901	5,428

* FIRE = Finance, insurance, and real estate.

Source: Historical data from Bureau of Labor Statistics, Bulletin 2307, *Employment and Earnings*, monthly, January issues; and unpublished data. Projected data: Coopers & Lybrand calculations.

Misclassified Workers. Because the IRS continues to cite their 1984 study on misclassified workers (see the Commissioner's April 22, 1994 letter), we have chosen those underlying figures as our reference point in making our revenue estimate of possible compliance policy changes. It is important to note that the vast majority of independent contractors are not misclassified workers. Nonetheless, as the 1984 IRS data show, the population of misclassified workers is a subset of this larger pool of persons.

The IRS data report the number of misclassified workers and the amount of misclassified compensation and distribute these estimates by major industry sector. Unfortunately, 34 percent of the misclassified employees (including §530 employees) are not classified by any particular industry and 30 percent of the misclassified compensation is not associated with any particular industry. Consequently, we have increased each of the industry-specific figures — both numbers of persons and compensation — to account for these understatements. The very reasonable assumption underlying this technique is that, in the absence of information to the contrary, amounts not classified by industry are likely to be distributed in proportion to those amounts which are classified by industry. In other words, there is no reason to suspect industry-specific bias in the under-reporting of sectoral information. The 34 percent of misclassified workers who are not classified by industry calls for the "blow-up" factor of about 52 percent (.34 divided by the sum 1 minus .34) to be applied to each of the industry-specific number of misclassified workers identified by the IRS.

Disregarding agriculture and mining, after increasing the industry-specific IRS data for unclassified amounts, the number of misclassified workers (including those protected by §530) ranges from a low of 83,000 for those in the transportation sector (including utilities and communications) to 1,322,000 for those in the service sector (including government). These numbers are shown in Table 6 below for these and the other industries upon which this study focuses. Also shown are our projections of these numbers to the year 2005. These projections are based on projected numbers of self-employed persons (described above) and on the assumption that the fraction (although not the absolute number) of independent contractors who are misclassified workers in each industry in 1984 remains constant.

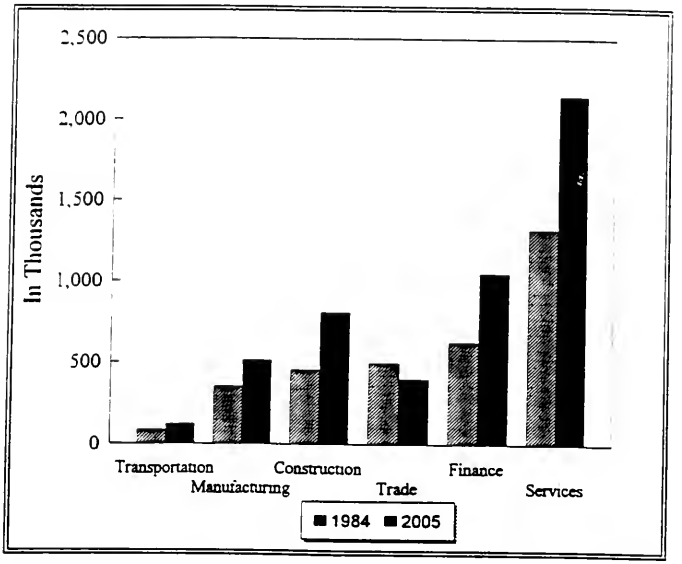
Table 6: Estimated Number of Misclassified Workers, By Selected Sectors
(Including §530 Protected Workers)
(In Thousands)

	1984		2005	
Industry	Number	Rank	Number	Rank
Services	1,322	1	2,147	1
Finance	629	2	1,051	2
Trade	498	3	401	5
Construction	454	4	809	3
Manufacturing	350	5	514	4
Transportation	83	6	120	6

Source: Figures for 1984 are derived from IRS table; those for 2005 are C&L calculations.

The figures appearing in Table 6 are shown graphically on Chart 2, which ranks industries from left to right according to the number of misclassified workers they are estimated to have had in 1984.

Chart 2: Estimated and Projected Number
of Workers Misclassified as Independent Contractors,
By Selected Sectors, 1984 and 2005



Source: Figures for 1984 are derived from IRS table; those for 2005 are C&L calculations.

Misclassified Compensation. Using a methodology similar to that which was used to account for the misclassified workers whom the IRS was not able to classify by industry, each of the industry-specific misclassified compensation [16] amounts reported by the IRS for 1984 was increased by about 43 percent (.30 divided by the sum 1 minus .30). This is because only 70

[16] "Compensation", used as the basis for the revenue estimate, is defined for this purpose by the IRS as wages and salaries that, except for misclassification, would have been paid to workers. In some cases, reclassification would also result in disallowance of work-related deductions to workers and allowance of the same deductions to the employer. In those cases, both compensation and work-related deductions would be reclassified. For the purpose of the revenue estimate, we ignore the effect of reclassification of deductions. Basing the revenue estimate solely on compensation may actually understate the revenue effect, in that employers are likely to have a higher rate of compliance with respect to work-related deductions than will misclassified workers.

percent of the misclassified compensation amounts were classified by industry. The remaining 30 percent were unclassified by industry.

Estimates of misclassified compensation in 1984 were extrapolated to future years by the following methodology:

- First, misclassified compensation was "grown" by the projected increase in the number of misclassified workers.
- Second, in order to account for changes in productivity and inflation, misclassified compensation was further increased by the growth in the implicit gross domestic product (GDP) deflator. For this purpose, the Congressional Budget Office (CBO) forecast of inflation was applied to each future year's real compensation through 1999 and (consistent with the CBO's own methodology for estimating the impact of federal Health Care Reform proposals) the final year's forecast of 2.5 percent inflation was held constant through the year 2005.

According to the 1984 IRS statistics on misclassified compensation, $2.2 billion of the $16.0 billion — or approximately 14 percent — of misclassified compensation was protected against reclassification by §530. Section 530-protected misclassified compensation was held in the same proportion to unprotected misclassified compensation as applied to the 1984 IRS figures. Consequently, for each year, it is assumed that approximately 14 percent of the total misclassified compensation would be protected by §530.

Effect on Calendar Year Tax Liability. In order to determine how much revenue is lost by the U.S. Treasury as a result of misclassified compensation, appropriate income and payroll tax rates must be applied. A revenue estimate of the impact of reclassification of misclassified compensation resulting from greater diligence on the part of IRS compliance personnel, from the introduction of improved compliance procedures, or from repeal of §530 requires further assumptions regarding the resources that IRS will be willing and able to bring to bear to ensure the intended result.

Based on assumptions the Treasury employed in its report on the taxation of technical services personnel, we determined the federal revenues lost due to the misclassification.

Unemployment Insurance (FUTA[17]) averaged 0.55 percent of total compensation.[18] A more significant source of lost revenue, however, is the lesser degree of income tax and payroll tax compliance independent contractors exhibit. The Treasury report notes that the SVC-1 study also found that, in instances of misclassification, independent contractors who were issued a Form 1099 reported 77 percent of their compensation, on average, but that in instances when no form was received — 26 percent of the time — only 29 percent of compensation was reported.[19] We assumed that this pattern of behavior has not changed and therefore applied the SVC-1 percentages to the compensation we determined to be misclassified. We also made the conservative assumption that all of those who failed to report income are in the lowest income tax rate bracket, 15 percent, and that they would also be liable for payroll tax contributions at a combined self-employed rate of 14.13 percent.[20]

Based on this information we derived an overall effective tax rate of 10.9 percent, which combines the effect of FUTA under-reporting and improved income tax and payroll tax compliance.[21] We apply this rate to total misclassified compensation for each year over the 1996-2004 projection period (ignoring any statutory changes in tax rates or bases scheduled for those years).

The technical staffs of the Treasury Department's Office of Tax Analysis (OTA) and the Joint Committee on Taxation (JCT) are officially responsible for estimating the revenue consequences of changes in tax law for the Administration and the Congress, respectively. Although they work in close cooperation, occasionally their estimates will differ. One of the

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[17] Federal Unemployment Tax Act.

[18] See footnotes to Tables 2-2 through 2-6 of the report *Taxation of Technical Services Personnel.* We assume all of the unemployment tax is FUTA, even though a small percentage is likely to be attributable to individual State programs. However, we exclude the entire effect of workers' compensation, estimated to be 1.0 percent of total salary, because only a small proportion of revenue are not directed to State-administered programs.

[19] See *Taxation of Technical Services Personnel*, p.54.

[20] The self-employed payroll tax statutory rate equals 15.3 percent, but in calculating their income tax liability independent contractors may reduce their adjusted gross income by half the self-employment payroll tax. Our figure conforms with the figure used by the Treasury in its report on technical services personnel.

[21] Calculation: ((1.0 minus (.29 times .26) + (.77 times .74)) * (.15 + .1413)) + .0055.

most important reasons for such differences is that the OTA estimates are based, in part, on the economic forecast published in the *Economic Report of the President* and that underlies the President's budget, while the JCT estimates are based, in part, on the CBO economic forecast. These two underlying economic forecasts can sometimes differ significantly from one another.

With respect to revenue estimates resulting from changes in the level of enforcement of the tax laws, both technical staffs are generally skeptical of the ability of the IRS to marshall sufficient resources to bring about full compliance with stated policy objectives. Consequently, they sharply discount the revenue estimates that they would otherwise apply if the provision in question were, say, a change in tax rate rather than a compliance measure. Our estimates are not discounted. In other words, we have assumed that adequate resources would be allocated to ensure that repeal of §530 or reclassification of other misclassified compensation (unprotected by §530) would result in the Treasury receiving in tax collections the full amount of assessed tax liability.

Based on these above assumptions, we calculated that the repeal of §530 would result in additional tax liability of $500 million in calendar year 1996. Reclassification of all misclassified workers would result in a tax liability increase of $3.3 billion in calendar year 1996.[22]

Effect on Fiscal Year Receipts. The last step in producing a revenue estimate is to factor into the estimate the lag by which actual tax collections fall behind accruals of tax liability. For example, if a particular change in tax law affects withheld tax payments, the revenue impact will be fairly current since withheld taxes (income or payroll) are collected at the source whenever

[22] These very conservative assumptions will tend to understate the overall revenue loss since (a) some taxpayers are likely to face income tax rates higher than 15 percent and (b) the extent of non-reporting may have increased over the past decade (when the Treasury study was conducted) since tax return audit rates have declined. Partially offsetting these factors, however, may be the possibility that some taxpayers' overall wages may exceed the Social Security wage ceiling (for the Old Age and Survivors Insurance and Disability Insurance programs) and that others may have incomes that fall below the federal taxable income threshold. Consistent with the Treasury Department methodology, these figures do not take into consideration the larger Social Security benefits that are likely to be paid in the future if individuals' payroll tax contributions increase. Because the amounts of revenue involved in §1706 are so small, we have not had to take explicit account of the impact of §1706 in our projections. This is based on the JCT's 1986 formal revenue estimate that §1706 raises an average of only $12 million per year and on the Treasury Department's 1991 report to the Congress suggesting §1706 has only negligible, if any, revenue consequences.

wages are paid and are turned over to the government shortly thereafter. For another example, consider a tax law change that is likely only to increase end-of-year payments (or, equivalently, to decrease end-of-year refunds). In such cases, the government's actual receipt of tax collections will lag behind the accrual of tax liability by as much as one year or more.

Because reclassification will generally result in personal income tax and FUTA being withheld by the employer, we assume taxes are collected concurrently for the month in which the liability is incurred. Therefore 75 percent of tax liability in any calendar year would be attributable to collections in the fiscal year that ends September 30 and 25 percent attributable to collections in the following year.

Table 7 shows the estimated increase in fiscal year tax receipts that would result from repeal of §530 and the additional increase that would result from full reclassification of misclassified workers. Assuming a January 1, 1996 effective date and assuming adequate enforcement to compel compliance with the classification rules, repeal of §530 would raise tax revenues $0.3 billion in fiscal year 1996, rising to $0.7 billion by 2004, eight years later. The total revenue raised during the nine-year period, 1996-2004, is estimated to be $4.9 billion.

Expanding this estimate to capture all misclassified compensation would raise another $2.1 billion in fiscal year 1996, for a total revenue increase of $2.5 billion that year. By fiscal year 2004, the additional annual revenue increase would rise to $4.1 billion, or a total of $4.7 billion when repeal of §530 is included. Over the nine-year period ending in 2004, the total increase in tax revenue (including repeal of §530) would be $34.7 billion — or more than $3.8 billion per year on average.

Of these totals, approximately 5 percent is attributable to increases in FUTA taxes from switching persons from self-employed to employee status and approximately 95 percent is attributable to income and payroll taxes of those who are not complying. These estimates do not include any increases in State tax revenues which would accompany changes at the federal level.

Table 7: Estimated Revenue Impact Resulting From Correction of Misclassified Independent Contractors* Fiscal Years 1996-2004 ($billions)

Proposal	Year									Total 1996-2004
	1996	1997	1998	1999	2000	2001	2002	2003	2004	
Repeal Section 530 Only	0.3	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.7	4.9
Correct remaining misclassifications	2.1	2.9	3.1	3.2	3.4	3.5	3.7	3.9	4.1	29.9
Total	2.5	3.4	3.6	3.7	3.9	4.1	4.3	4.5	4.7	34.7

* Estimates assume adequate enforcement resources.
Note: Details may not add to totals because of independent rounding.
Source: Coopers & Lybrand calculations.

VII. Conclusion

Evidence of misclassification of workers has been found for numerous industries and occupations over the past 15 years. Studies performed by the IRS and GAO have indicated that there is a significant segment of employers which may deliberately treat their employees as independent contractors. Using a combination of unpublished IRS data and information from the BLS, we have attempted to update this information by estimating the potential number of misclassified workers within different industries and the federal revenues losses associated with their misclassification.

Our results suggest that misclassification causes federal tax revenues to be lower than they otherwise would be during the 1996-2004 period by between $2.5 billion and $4.7 billion annually. Our projections do not take into consideration the likely impact the additional payroll tax a number of the current health care reform proposals include to fund universal health care coverage may have. Such increases will certainly induce additional employers and workers to consider a shift to independent contractor status in order to avoid the proposed tax and to qualify for the subsidies that may be offered to uninsured workers. The resulting changes in employment status will likely cause further increases in the revenues lost from misclassification.

Addendum B

MAINTENANCE INC.
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(214) 369-0990

September 14, 1994

The Honorable Charles B. Rangel
United States House of Representatives
Washington D.C. 20515

Dear Congressman Rangel:

Over the last thirteen years, our company has repeatedly reported to the Dallas Internal Revenue Service ("IRS") firms who utilized "subcontractors" to perform the identical work as employees. The history of the janitorial service industry has always been to use employees. Subcontracting first appeared in what is primarily a Dallas problem in 1981. This was three years after Section 530 was passed in the Revenue Act of 1978. The Act clearly stated that if subcontracting was not established as the norm prior to 1978 than only employees would be utilized by employers in each respective industry.

In October of 1989, Mr. Gary O. Booth, District Director for the Dallas IRS, stated in a meeting that subcontracting was definitely and clearly illegal in the janitorial service industry.

The problem now arises that the majority of janitorial contracts in Dallas (and recently across the nation) are still being performed with subcontract labor. Companies that supposedly have been investigated and fined continue to clean buildings with subcontractors. Currently, it appears that several contractors have had their hands slapped over paperwork problems but subcontracting is openly discussed, legal and many large contractors continue to bid and perform work with "subcontractors".

The pricing of services in the Dallas market has dropped over 30% over the last seven years and our firm is placed at a huge cost disadvantage. I estimate that over 4,000 employees have lost their jobs and related benefits to "subcontractors" in the Dallas market alone. The IRS is also losing millions in revenue.

Our company has been patient and followed the rules and we estimate a personal loss of business of $5,000,000 annually and our management and employees are handicapped by the pricing dilemma.

I would appreciate your efforts to rid the nation of all safe harbor (Section 530) rulings. These rulings create an unfair playing filed which enable "super companies" to be formed. These "super companies" who hire subcontractors, do not have to pay

federal FICA or FUTA taxes nor must they comply with federal regulations such as I-9's, wage per hour laws, ADA and OSHA. Therefore, these "super companies" have an extreme cost advantage over law abiding firms that hire employees. The entire situation is un-American and is a disgrace to the backbone of our country, small business.

I hope you will address the misclassification issue immediately.

Sincerely,

Sally B. Garrett
Executive Vice President

Kern Commercial Cleaning
SINCE 1971

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September 22, 1994

The Honorable Charles B. Rangel
Chairman Select Revenue Measures
1105 Longworth House Office Building
Washington, D.C. 20515

Re: Misclassification of Workers

Dear Mr. Chairman:
You are aware of the problem created for legitimate American businesses, and for the nation as a whole, by companies misclassification of workers as independant contractors. In California, there are cleaning companies that are notoricus for this.

My company provides floor maintenance and related services to retail stores in California. It is becoming impossible to compete with these illegal companies.

Legitimate contractors, including myself, are losing business to those which are able to offer lower prices as a result of evading payment of payroll related taxes and workers compensation insurance by such misclassification practices.

Our company lost $703,000 in sales during each of the last two years to one cleaning service alone, as a result of their ability to offer lower prices by utilizing such exploitative practices. This resulted in 38 lost jobs in my small company alone! Conversely, this competitor has grown from a one man operation, to $6,000,000 in annual sales in two years. That company is now dominating the retail floor service market in central, eastern and southern California. They employ 300 people that have replaced 300 taxpayers in the work place.

This has created multiple problems:

1. Taxpaying employees with a right to work are being replaced by illegal workers that do not contribute their share of taxes to the state and federal government. As a result, there is a tremendous loss of very necessary revenue to the government at a time when everyone in government is screaming for more money.

2. Additional loss of government revenue results from legitimate, tax paying business losing sales that result in taxable income. Very often, these legitimate companies are completely going under.

3. American taxpayers continue losing jobs while undocumented, illegal workers continue to stream across borders due to the opportunity fed by this practice.

4. Illegal contractors create an unfair working environment for minorities by not providing them with benefits otherwise prescribed by law, such as workers compensation insurance, disability insurance, social security and minimum wage. Since most employees hired by such companies are undocumented, illegal aliens they do not have any recourse and find themselves victimized by greedy exploiters.

Retail stores that receive services provided by such illegal contractors benefit by receiving lower prices. Although retail chain stores are aware of the way these illegal contractors do business, they aren't about to say anything and spoil their own benefit, because they need to save money themselves. There are no repercussions to them, so they benefit by "looking the other way" and hiring the illegal contractors over the legitimate ones. My concern for the seriousness of this issue was expresed well by your colleague Representative Lantos (D-12th CA):

"You are looking at a nationwide pattern of fraud which penalizes the law-abiding citizen, which punishes the law-abiding business, which punishes the law-abiding worker, but benefits the crooks and the avoiders and the evaders of their responsibility..."

It is important to point out that the single largest cost to a cleaning company is labor. Labor related costs, such as liability insurance, workers compensation insurance and the employers portion of taxes, add significantly to the contractors direct costs of providing service to customers. In fact, these costs are the next highest cost of providing service. Each of these costs is directly tied to payroll. The goal of the illegal contractor is to evade the payment of the labor related additional costs by eliminating, as much as possible, the so called "payroll", from the accounting record. This "saved money" either is taken as additional profit, or enables the illegal contractor to charge lower prices. This is accomplished by setting up false "subcontractors" for their labor. It is a well thought out process that is explained in the attached supplement.

We have successfully discovered information on one of our competitors, who admitted 5 "subcontractors". The bank and personal checking account used to pay employees was also discovered. This suggests that it should be fairly simple to obtain records of that bank account and demonstrate the willful intent to defraud the employees and government. Reviewing the copies of canceled checks and bank statements would prove that this competitor used this account to pay employees and evade taxes. This competitor justifies it as legal, because he used an attorney and CPA to set it up. However, as the supplement shows, it is an intricate scam.

Some one is supposed to be responsible for the payment of taxes! And, the major point here is that proper liability insurance, workers compensation insurance, and payroll taxes are not paid by anyone; the employee; the "subcontractor" nor the contractor. This is what enables them to sell service at a lower price. This continues to cost taxpayers their jobs, and the government loss of revenue. This scheme promotes the unfair treatment of minority workers.

The opportunity for financial gain appears to be worth the calculated risk of being caught. In the interim between the inception of the scam and discovery, notable wealth is acquired.

The owner of the cleaning service has said, "If Company X can do it so can I," "If I am caught I will just pay the fine ...and keep the rest". Such thinking is demonstrative of willful intent.

We are working with the IRS requesting that action be taken. Having such information in hand should be sufficient proof to demonstrate that they are willfully operating such a scam.

For some reason the matter remains unsettled after 2 years and this competitor continues to grow.

At the expense of money, time and effort, we are currently seeking further information to provide to the IRS. Contractors such as myself, need a level playing field so that we can have an opportunity to conduct business legally and compete fairly.

Action is necessary on the issue of proper classification of employees. There are many other potential problems that hinge on settling the issue of proper employee classification. For example, if the proposed health care initiative is enacted, companies that misclassify workers will gain a further unfair advantage over legal, ethical contractors by further escaping the legitimate cost of doing business. Unless the government is able to clarify and enforce the proper classification of workers, the well intended health care initiative will be side stepped. Many more will view that opportunity as sufficient motivation to misclassify employees as independent contractors. This will further widen the gap between the price that must be charged by legitimate companies that must account for all costs, and that of the companies operating illegally. More jobs will be taken away from taxpaying workers and given to tax evaders. The health care benefit still will not be received by those for whom it is intended even though it is mandated. For a law to benefit citizens it must be enforceable! Allowing the misclassification issue to remain unsettled nurtures the opportunity to skirt other obligations.

On behalf of myself, my employees and law-abiding building service contractors across the nation I wish to express my sincerest appreciation for your taking the initiative to bring a resolve to this important issue. Myself and the Building Service Contractors Association International welcome the opportunity to work with you and your staff on this matter.

Respectfully submitted,

Frank A. Muñoz, CBSE
Kern Commercial Cleaning
Bakersfield, CA

ONE FRAUDULENT APPROACH THAT IS WORKING

Let's use a fictitious Comapny "X" for the sake of example. This is one way this scam works :

Company X has "set up" several of their supervisory employees as "subcontractors" by executing a formal written agreement with each one to provide labor for them. The agreement is prepared by an attorney and reviewed by a CPA. Assuming that all parties will perform as outlined, the arrangement receives a stamp of approval as "legal". The agreement states that the "subcontractor" is responsible for paying required taxes and insurance on employees. Company X then obtains a small insurance policy and pays "payroll" on a few Company X administrative employees. The insurance premiums and taxes are paid on these. This enables accounting records to show payment of some "payroll" and "payroll taxes". In an audit, this record will match bank records. It gives the whole thing an appearance of legitimacy.

On the other hand, the bulk of the companies payroll is handled much differently. Each "subcontractor" opens a personal checking account under a different name. Employees are paid out of each of these personal, unreported accounts. The subcontractor does not report these wages TO ANYONE.

The "subcontractor" obtains an insurance certificate under false pretense. He also pays only a minimum insurance rate, since the actual labor dollars are unreported and untraceable by those that do not have knowledge of the personal bank account used to pay wages. Yet, he provides Company X with the certificate of workers compensation and liability insurance required by the written agreement. All of this is done so that it appears that Company X does not have to pay for insurance premiums due on the wages paid to employees. No one pays the taxes due on this unreported payroll!

The certificates given to Company X by the "subs" appease the insurance company that insures Company X. Company X pays only a minimum amount to them instead of a rate based on the full, actual payroll of all workers employed. Company X thus gets a certificate of insurance to give it's customers. It appears that insurance is legitimately provided.

(It should be noted that to an attorney writing the initial agreement and a reviewing CPA, it is presumed that the "subcontractor" will provide proper insurance coverage for all concerned, as provided in the agreement. So thinking, the attorney and CPA will say that the arrangement is legal.)

On the surface, this all looks legitimate. However, the "subcontractor" himself, who hires and manages all of the cleaning workers, does not report any of their wages to respective agencies either. It now looks as though there are no employees! Payroll withholdings are not taken and paid to the federal or state government, just as insurance coverage is not provided for unsuspecting employees.

In our actual experience involving one such contractor, we find that despite how it may appear, work is all directed by the contractor. Even the owner and his salesman regularly walk into the stores they contract and direct workers. The contractor owns the equipment, provides product and all employees on the job site believe they work for the contractor. They wear shirts bearing the contractor's emblem. The name of the "subcontractor" is only known to the principals involved. This is where the challenge lies. It requires alot of effort to uncover the bank accounts that can be audited to trace payments to employees.

Some one is supposed to be responsible for the payment of taxes! And, the major point here is that proper liability insurance, workers compensation insurance, and payroll taxes are not paid by anyone; the employee; the "subcontractor" nor Export. This is what enables them to sell service at a lower price. This continues to cost taxpayers their jobs, and the government loss of revenue. This scheme promotes the unfair treatment of minority workers.

Addendum C

Arent, Fox, Kintner, Plotkin & Kahn

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Allen G. Siegel
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April 3, 1990

Mr. David G. Blattner
Assistant Commissioner (Examination)
Internal Revenue Service
Room 2501
1111 Constitution Avenue, NW
Washington, D.C. 20224

Dear Mr. Blattner:

We previously sent you a letter, dated May 24, 1989, on behalf of the Building Service Contractors Association International ("BSCAI"), in which BSCAI stated its belief that building service companies' treatment of maintenance workers as independent contractors, rather than as employees, is not in accordance with any long-standing, recognized practice of a significant segment of the building service industry, as sanctioned by Section 530(a)(2)(c) of the Revenue Act of 1978. A copy of that letter is enclosed for your convenience.

BSCAI and some of its members have continued to investigate and monitor this subject; i.e., the misclassification of maintenance workers as independent contractors. It appears that this practice is particularly prevalent in the areas of Atlanta, Dallas and Houston. Further, it is predictable that the practice will grow nationwide as a reaction to the recent legislation increasing the minimum wage. Obviously, the competitive advantage enjoyed by companies who treat their maintenance workers as independent contractors will only expand when the wages paid to employees by the remaining employers increase.

Arent, Fox, Kintner, Plotkin & Kahn

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May 24, 1989

Mr. David G. Blattner
Assistant Commissioner (Examination)
Internal Revenue Service
1111 Constitution Avenue, N.W.
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Washington, D.C. 20224

Dear Mr. Blattner:

We represent the Building Service Contractors Association International ("BSCAI"). It has come to BSCAI's attention that the Internal Revenue Service is in the process of examining the practice in the building service industry of treating maintenance workers as independent contractors or as employees, for purposes of Section 530(a)(2)(C) of the Revenue Act of 1978. As will be explained more fully below, BSCAI submits that treatment of maintenance workers as independent contractors, rather than as employees, is not in accordance with any long-standing, recognized practice of a significant segment of the building service industry.

BSCAI is a private, non-profit association chartered in the District of Columbia. Founded in 1965, BSCAI's members currently consist of approximately 1,500 building service contracting firms throughout the United States, and an additional 100 firms outside the United States, which, in

COMMITTEE ON SMALL BUSINESS
HEARING ON DEFINITION OF
INDEPENDENT CONTRACTOR UNDER THE TAX CODE

January 19, 1995

Submitted by: Cheryl M. Bass, R.N., President
American Professional Temporaries, Inc. and
American Professional Home Health, Inc.
5216 Broadview Road
Parma, Ohio 44134

(216) 661-3848

Ms. Chairwoman and members of the Committee, I am Cheryl M. Bass. I am a nurse and President of American Professional Temporaries, Inc. and American Professional Home Health, Inc. of Parma, Ohio. My companies are among the many small businesses that comply with the employment tax laws by classifying our workers as employees and have been damaged by competitors which misclassify their workers as independent contractors.

My companies are members of the Home Health Services and Staffing Association (HHSSA) which is an association of large and small businesses providing supplemental nursing staff to health care facilities and home health services directly to patients. All of these companies treat their supplemental staffing workers as employees in accordance with the IRS' consistent application of the employment tax laws to our industry. [1] HHSSA is a member of the Coalition for Fair Worker Classification, which is a coalition of associations representing large and small businesses, as well as management and labor, and who feel that legislation is needed to curb the intentional abuse of the independent contractor designation.

I treat all of the nurses who work for my companies as employees because that is the appropriate designation under the law according to opinions from national staffing and home health associations, experienced legal counsel, and the IRS itself. In the past several years, my companies have suffered severe damage from competitors who provide exactly the same staffing services but intentionally misclassify their workers as independent contractors. We cannot compete on price with companies that evade the expense of withholding and paying employment taxes.

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[1] Technical Advice Memorandum 9135001 (February 28, 1991); Technical Advice Memorandum 8913002 (December 8, 1989); Private Letter Ruling 9122020 (June 4, 1991); Revenue Ruling 75-101, 1975-1 C.B. 318.

providing for unemployment and workers' compensation insurance, as well as complying with the requirements of the Fair Labor Standards Act, the Occupational Safety and Health Act, and other state and federal laws that apply to employees. In one year alone, I lost three major hospital clients to companies that under-cut our prices by misclassifying their workers

The abuse of the employment tax laws which I have seen in the medical staffing field also occurs in other fields and is growing, as documented in at least six prior congressional hearings.[2]

If control over the way a job is performed is a criterion for determining a worker's status, then nurses who work in areas such as operating rooms and intensive care wards of hospitals must be regarded as employees in order to protect public health and safety. It is legally and practically imperative for the services of nurses who work in such settings to be provided in accordance with the institution's policies and protocols and as part of an integrated team.[3]

The current situation is untenable. The criteria for distinguishing between employees and independent contractors are notoriously ambiguous. Companies, both large and small, are increasingly exploiting that ambiguity to gain an unfair competitive advantage over law-abiding companies. Yet a provision in the law (at § 530) prohibits clarification.

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2 "The Pros and Cons of Home-based Clerical Work," Subcommittee on Employment and Housing (1986); "Rising Use of Part-time and Temporary Workers: Who Benefits and Who Loses?", Subcommittee on Employment and Housing (1988); "Exploiting Workers By Misclassifying Them as Independent Contractors" Subcommittee on Employment and Housing (1991); "Repeal of Section 530 of the Revenue Act of 1978," Subcommittee on Select Revenue Measures (September 21, 1993), "Classification of Workers as Employees or Independent Contractors Under Health Reform," Senate Committee on Finance (1994). See specifically "Contractor Games: Misclassifying Employees as Independent Contractors," Committee on Government Operations, H. Rep. 102-1053, 102d Cong., 2d Sess. 10 (October 16, 1992)(hereinafter "Contractor Games").

3 Accreditation Standards for Hospitals, Joint Commission on Accreditation of Healthcare Organizations, §§ NC.2-NC.5.6, SE.4, SP.1-S.5.4 (1993); 42 C.F.R § 482.23.

Intentional misclassification is an abuse that we should not have to tolerate and certainly cannot afford. The General Accounting Office has found that "much" of the $20.3 billion annual tax gap is attributable to the misclassification of workers [4] The accounting firm of Coopers and Lybrand recently issued a report projecting that the federal government will lose approximately $35 billion over the next nine years as a result of worker misclassification.[5] At a time when Congress is contemplating cutting spending for Medicare services to the aged and disabled, preservation of a costly loophole in the employment tax laws is indefensible.

As a member of the vast majority of small businesses that properly classify their workers, I request that Congress enact legislation that provides for clarification of the distinction between employees and independent contractors, repeals the provision in § 530 that prohibits such clarification, and phases out the "safe harbors" which allow companies to misclassify their workers with impunity.

I have reviewed H.R. 3069, introduced in the last Congress by Congressmen Christopher Shays (R-CT) and Tom Lantos (D-CA), and strongly support it. As I understand the bill, it would (a) establish a process to ensure that the employment tax laws are applied in a similar manner to similar businesses, (b) remove the prohibition on the IRS to issue clarifying regulations, (c) narrow the § 530 safe harbors to prevent intentional misclassification, and (d) require tax payers to inform workers of the consequences of being classified as an independent contractor. I believe the bill could be improved by fully phasing out the safe harbors after the issuance of clarifying regulations, but it is a large step in the right direction and is far superior to any other legislative proposal which has been made. In any event, it is clear that legislation curbing abuse of the employment tax laws is supported by Republicans and Democrats, large and small businesses, and management and labor.

I will submit the remainder of my remarks for the record and be glad to answer any questions.

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4 "Tax Administration: Approaches for Improving Independent Contractor Compliance," GAO/GGD-92-108, 23-24 (July 23, 1992)(hereinafter "Tax Administration"); "Contractor Games," 5-6.

5 "Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers," Coopers & Lybrand, 3 (July 1994).

ADDITIONAL REMARKS FOR THE RECORD

The following findings have been made in the course of the six prior congressional hearings in recent years on the subject of misclassification of workers

1. Intentional misclassification of employees as independent contractors is a pervasive and growing practice.[6]

2. Misclassification of workers deprives federal and state governments of billions of dollars annually in lawfully due revenues.[7]

3. Misclassification deprives workers of the benefits and protections of a broad range of laws, usually without their knowledge or against their will (e *g.*, unemployment compensation, workers compensation, disability insurance, Social Security and Medicare quarters of coverage, the Fair Labor Standards Act, the Occupational Safety and Health Act, the Americans with Disabilities Act, the Family Medical Leave Act, and employment discrimination laws administered through the Equal Employment Opportunity Commission).[8]

4. Misclassification of workers coupled with abuse of the § 530 "safe harbors" results in inequitable application of the employment tax laws which places law abiding companies "at a great competitive disadvantage."[9]

5. Companies that misclassify shift their share of the cost of programs such as unemployment compensation and workers compensation to law abiding employers.[10]

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6 "Contractor Games," 10.

7 "Tax Administration: Approaches for Improving Independent Contractor Compliance," GAO/GGD-92-108, 23-24 (July 23, 1992)(hereinafter "Tax Administration"); "Contractor Games," 5-6.

8 "Contractor Games," 2-4.

9 "Contractor Games," 2-3, 8; "Tax Administration," 6-7

10 "Contractor Games," 8.

The following arguments have been made by those who seek to preserve the current ambiguity in the employment tax laws:

1. Argument: Those who seek clarification of the employment tax laws desire to eliminate or reduce the use of legitimate independent contractors.

   Response: No. HHSSA and the Coalition for Fair Worker Classification do not seek to eliminate or reduce the legitimate designation of workers as independent contractors. Rather, these groups have sought legislation which would provide for clarification of the law without requiring reclassification of workers as employees or independent contractors. Once the law is clarified, however, those companies that are misclassifying workers under a "safe harbor" should be required to comply with the clarified definition in order to avoid an inequitable application of the law.

2. Argument: Clarification of the law will allow the IRS to act in a harsh and arbitrary manner.

   Response: Wrong. If the ambiguity in the law is clarified, then the IRS will have less latitude to act arbitrarily. Moreover, if the law is easier to understand, most tax payers will comply with it voluntarily, secure that they are not likely to be subjected to an unreasonable audit.

3. Argument: There is no need to phase out the "safe harbors" under § 530 because the "consistency" language in the provision prevents companies from "gaming" the system by redesignating workers as independent contractors.

   Response: Wrong. The "consistency" principle is easily circumvented by those who desire to intentionally misclassify workers by simply establishing a new corporation and transferring the workers to that corporation. Of course, the "consistency" principle presents no impediment to a new company that wishes to misclassify.

4. Argument: The classification of workers is so complicated that it should be accomplished one industry at a time through the IRS' "Compliance 2000" program.

   Response: This is essentially an argument for infinite delay. The Compliance 2000 program is proceeding exceedingly slowly, and negotiations between the IRS and some industry groups have broken down completely. In the more than two years the program has been in existence, criteria for the classification of workers have been issued for only one industry. According to one IRS official

working on that program, proper classification of workers will take "100 years" at the rate that program is proceeding.

For more information, call

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Statement of

The Associated General Contractors of America

Presented to the

House Committee on Small Business

on the

Role of Independent Contractors

in the

Construction Industry

January 19, 1995

The Associated General Contractors of America (AGC) is a national trade association of more than 33,000 firms, including 8,000 of America's leading general contracting firms. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, water works facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects and site preparation/utilities installation for housing development.

The Associated General Contractors of America
1957 E Street N.W., Washington, D.C. 20006-5199, (202) 393-2040, Fax (202) 347-4004

Good afternoon. My name is Keith R. Fetridge and I am Director of Construction Industry Services with Aronson, Fetridge, Weigle & Stern located in Rockville, Maryland. Our company is a small business CPA firm specializing in audit, tax and consulting services for closely held construction businesses. I also serve as a member of the Tax and Fiscal Affairs Committee of the Associated General Contractors of America and I am before you today in that capacity.

The Associated General Contractors of America (AGC) is a national trade association comprised of more than 33,000 firms, including 8,000 of America's leading general contracting companies. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, water works facilities, multi-family housing projects and site preparation/utilities installation for housing development. Many AGC member firms routinely contract with independent contractors to perform work in many different states and localities, helping to add to the value of vigorous competition on construction projects in these markets. Independent contractors are a particularly valuable resource to the small business contracting community. Small general contractors often choose to employ specialists and look to independent contractors to perform particular tasks related to a job. Thus, it is critical that Congress retain the Section 530 safe harbor provisions as currently in effect.

On behalf of AGC, I welcome the opportunity to testify on the need to preserve the legitimate use of the independent contractor in the construction industry as well as the preservation of Section 530. It is common for many contractors throughout the country to employ independent contractors skilled in numerous construction trades. In most all of these cases, the independent contractor supplies the tools and materials for the job, owns his or her own vehicles, pays into his or her own retirement plan, and does not require technical assistance from the general contractor as to how to perform the task. The general contractor's role is to inspect the work as it progresses in order to insure that the job is done properly.

While my clients and AGC members practice the legitimate use of independent contractors, I am aware that some contractors may be classifying individuals as independent contractors when they should be treated as employees. AGC advocates preserving the use of independent contractors when such a relationship is legitimate.

Background

Worker misclassification is an old issue both for the Internal Revenue Service (IRS) and employers. AGC has been working with the IRS for the past three years to resolve

differences related to the 20 point common law test used by both the Service and the construction industry to determine proper worker classification. The goal of AGC and the IRS working together in this effort has been to identify those critical three or four factors for certain worker groups that could be used to determine whether or not someone should be properly classified as an independent contractor.

A variety of occupational relationships and job classifications exist in the American workplace and in the construction industry. However, for Federal tax purposes only two classifications exist: a worker is either an employee or an independent contractor (i.e. self-employed). Significant tax consequences result from how a worker is classified; some of the tax consequences favor employee status, while others favor independent contractor status.

Section 530 Provisions

Section 530 of the Internal Revenue Act of 1978 was put into law in order to protect the legitimate use of independent contractors. This statute exists because Congress realized that independent contractors contribute a vast amount of added value to economic production and because it is not fair to change the rules after taxpayers organize their affairs according to good faith reliance on industry practice or prior IRS determinations. Congress enacted these protections for a number of reasons, but it is safe to say the legislative history of Section 530 supports the view that taxpayers are to be afforded wide latitude in asserting or maintaining independent contractor status.

Specifically, these protections were established because: individuals not under the control of others in the workplace bear all the risk and expense for their employment; they were increasingly vulnerable to the subjectivity of IRS audits in which their treatment as independent contractors had not been challenged and after private letter rulings or technical advice memoranda from the Service had said that they were independent contractors; or after they had relied on established common industry practice.

For Example

Consider a situation common to thousands of construction sites throughout the country. Individuals contract for short periods with one or more construction companies to perform certain work on construction projects. These individuals own their own trucks. They own their own tools. They pay into their own retirement plans. They are not told how to perform the work. And other contractors in the general geographic region are free to contract with these individuals, or others like them, to perform the same type of short term work.

By any objective standard, these individuals are not employees of the general contractor. But without the protection of Section 530, the Federal government may determine that they are, even after both parties had relied on historic industry practice or on prior IRS advice. Under that scenerio, if the government successfully prevails in a reclassification case against the independent contractor, that individual is then subject to withholding, social security and unemployment taxes. This retroactive "tax" would punish employers who have made a good faith effort to comply with the law.

Conclusion

The current law and rules for classifying workers for purposes of federal employment taxation are adequate. Furthermore, the Section 530 safe harbor provisions must remain in effect in order to protect the rights of general contractors and the legitimate interests of independent contractors. Finally, we are hopeful that our work with the IRS to simplify classification criteria will prove beneficial to all parties and will result in objective criteria that will be used to determine proper employment classification in the construction industry.

Thank you.

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January 19, 1995

Jan Meyers, Chair
House of Representatives
Committee on Small Business
23;61 Rayburn House Office Building
Washington, D. C. 10515

Dear Madam Chair Meyers:

These comments are submitted on behalf of the approximately 9,000 members of the National Association of Enrolled Agents (NAEA). Members of NAEA are professional individuals whose primary expertise is in the field of taxation. They have established this expertise by either passing the Internal Revenue Service's comprehensive two-day examination on federal taxation or by serving as an IRS employee in an appropriate job classification for at least five years. NAEA members maintain their expertise by completing at least 30 hours of continuing professional education each year. Our members work with more than four million (4,000,000) individual and small business taxpayers annually.

It is in our role as the voice for our members and the general taxpaying public that NAEA submits this letter and offers the following comments on this issue.

From its inception, the home office deduction has been a contentious issue. Over the years, the Internal Revenue Service has expended a considerable amount of time and resources defining and defending its position in this area at great taxpayer expense. The current law regarding this deduction, resulting from the Supreme Court's *Soliman* decision, has further clouded this issue.

In order to deduct an office in one's home it must be one's "principal place of business". The *Soliman* decision changed the way "principal place of business" is defined. The Supreme Court has identified two primary factors to be used to determine if a taxpayer's home qualifies as a "principle place of business". The two criteria are: (1) the relative importance of the activities performed at each business location, and (2) the amount of time spent at each location. To be deductible, the home office must be the place where the most important activities are performed, and also where the majority of the time is spent. Test #1 is applied first and if the answer to test #1 is inconclusive, test #2 applies.

NAEA views the *Soliman* decision's definition of a taxpayer's "principal place of business" as too restrictive and predicts its impact will be devastating on small businesses. This decision has resulted in a definition of "principal place of business" which is extremely difficult to determine and which according to IRS guidance qualifies very few taxpayers for the deduction. "Relative importance" is a very nebulous concept which is very arduous for taxpayers to comprehend. Consequently, the home office deduction remains a contentious issue over which the IRS, taxpayers and their representatives will continue to expend much time and monetary resources.

From a social and economic standpoint the *Soliman* decision is a disaster. More and more businesses are encouraging their workers to work from home and for many fledgling entrepreneurs it's a necessity. Home based workers don't have to commute to work thereby reducing air pollution and conserving our energy resources. It is interesting to note that in Justice Stevens' dissenting opinion in *Soliman* he pointed out that the home office is becoming more common in American society. He went on to write "In my judgement, the Court's contrary conclusion in this case will breed uncertainty in the law, frustrate a primary purpose of the statute, and unfairly penalize deserving taxpayers. Given the growing importance of home offices, the result is most unfortunate."

The House GOP "Contract With America" contains a proposal that would effectively repeal the *Soliman* decision. The home office deduction would be allowed if essential administrative or management functions regularly are carried on in the home office and the taxpayer has no other location for performing such functions. We support this definition of "principal place of business". It better reflects the reality of many legitimate home office situations than the current definition under *Soliman*. In addition, it would be much easier to ascertain compliance than the "relative importance" test. Consequently, fewer conflicts between the IRS and the taxpaying public would arise regarding this issue thereby substantially reducing the time and resources expended resolving differences.

The Supreme Court decision itself contains comments that would seem to support this approach to the definition of "principal place of business". Although Justice Stevens was the lone dissenter, Justices Thomas and Scalia concurred with the judgement only. In fact, Justice Thomas wrote "I write separately because I believe that in the overwhelming majority of cases...the 'focal point' test... provides a clear, reliable method for determining... 'principle place of business'. We granted certiorari to clarify a recurring question of tax law that has been the subject of considerable disagreement. Unfortunately, this issue is no clearer today than it was before we granted certiorari. I therefore concur only in the Court's judgement."

Clearly, the current law regarding the home office deduction leaves much to be desired from the standpoints of fairness, economic policy, social policy and administerability. It is our opinion that legislation along the lines of that contained in the House GOP "Contract With American" would address the current deficiencies in the law and create a vastly improved home office deduction.

Respectfully submitted,

Stephen DeFilippis

Stephen DeFilippis, EA
Co-Chair, NAEA Government Relations Committee

Statement of
Wayne Kaufman, United Homecraft, Inc.
before the
House Small Business Committee
regarding the
Status of Independent Contractors
January 19, 1995

Madam Chairman, honorable members of the Committee, I am thrilled to be asked to provide testimony on the issue of independent contractors. (I would like to ask that my statement in whole be included in the written record.) The treatment of independent contractors is probably the most important issue to home improvement contractors. Both IRS and state determinations in this regard often put remodeling firms out of business, and I have seen it happen. Fortunately, I have lived to tell the tale, but I fear they will be back.

My name is Wayne Kaufman and I am the co-owner of United Homecraft, Inc. United Homecraft is a full service remodeling firm located in St. Louis, Missouri, specializing in kitchens, baths, replacement windows, and all types of exterior siding. We have approximately 35 employees and utilize 20 to 40 independent subcontractors throughout the year. I serve as the Ethics Committee Chairman of the Greater St. Louis chapter of the National Association of the Remodeling Industry (NARI) and I currently serve as the Government Affairs Committee Vice Chair for the national NARI board of directors.

Independent contractors are an integral part of the home improvement industry. Small business general contractors, many of whom started out as independent contractors, commonly contract with specialized craftsmen to fulfill certain aspects of a larger home improvement project. Since each remodeling project is unique, especially for full service remodeling firms, various specialty trades are needed from one job to the next. Independent contractors or subcontractors are well suited to serve in these instances. They provide general contractors, such as my company, with flexibility and cost efficiency in offering varied multi-service projects to the homeowner. They allow us to meet changing service demands created by short term projects and specific client needs.

Subcontractors are a very independent breed. They prefer to pick and choose which projects they would like to work on. They want to be their own boss. They do not want to be employees; that is why they have struck out on their own.

For years, remodelers have struggled with the ambiguities surrounding the definition of an independent contractor. We have suffered financially due to the discretion afforded IRS agents in applying the 20 common law questions. Despite the Congressional moratorium issued in 1978, the IRS continues to aggressively audit and reclassify subcontractors as employees for

federal tax purposes. It is obvious that a bias exists in favoring employee status rather than allowing entrepreneurs to remain in business for themselves. From what I understand, the President's health care plan attempted to restore to the IRS the unlimited authority they wielded prior to 1978. Congress must enact clear, fair and objective standards and put an end to the confusion once and for all.

State employment commissions can be even more relentless. The consequences of a reclassification go beyond federal withholding, unemployment, Social Security and Medicare payments. Besides back taxes, penalties and interest, we are often held liable for state employment taxes, worker's compensation insurance, pension plan payments, and other employee benefits. An IRS or state employment audit often results in the unfortunate dissolution of the company.

I myself have undergone such an audit. In 1989, we were audited by two state officials. They reclassified as employees every single person we treated as an independent contractor. They even reclassified tradesmen who had their own trucks and tools, their own workers compensation insurance and general liability certificates, and their own federal tax identification numbers. They assessed us $1,600. We protested and waited for our hearing. This went on for a number of years with interest accruing. Then in 1993, the IRS got wind of our case. They agreed that the findings of the state audit were correct and assessed an additional $3,000 and levied our bank account. Keep in mind, our hearing was still pending. What's odd is that the state criteria are quite different from the IRS criteria yet the IRS did not conduct a separate audit. To make a long story short, after spending over $4,000 in attorney fees, we finally settled with the state for approximately $2,000. Our total costs amounted to $9,000. I am not pleased with this resolution but we had to move on.

I know of others with even worse stories. One company, B & L Construction in St. Louis, underwent an intensive three week employment audit by the IRS in 1990. The initial finding concluded in the assessment of a few hundred dollars which was paid. About a month later, the IRS said they would not accept its own audit and now wanted $80,000. After considering attorney's fees, time and effort, the company sought a settlement. So they settled for approximately $20,000 and the IRS promised they would not return to this matter. But they broke their promise and have been back time and time again. This company just received another assessment of $17,000. Recently, the owner, Bill Peterson, said he just couldn't take it any more. His breathing became difficult and he died on the way to the hospital at age 61. He was not a sickly man.

Other companies have been issued serious threats of repercussion, assessed huge amounts in back taxes and penalties, and have spent thousands of dollars in legal fees. Some of these companies have been fighting for over ten years. Many have settled, many have gone out of

business, others are still waiting for their hearing. (With your permission, I would like to submit these stories for the written record.)

So the question remains, what to do? I think, given the new Congressional climate, the time is ripe for Congress to tackle this issue and provide small businesses and the IRS with clear guidance that will allow us to easily determine who is and who is not an employee. A number of options should be considered including:

1. Enact a new safe harbor test.

NARI is working with a coalition headed up by the NFIB and the SBLC in developing a new independent contractor safe harbor test that is simple to understand and implement. The draft legislation is in the final stages and should be available very soon. We are certainly willing to discuss this in detail with you at a later date. For now, I would like urge the Committee to seriously consider such a bill. The proposal will allow general contractors to continue to use independent contractors as dictated by their business needs without fear of repercussion.

2. Change the IRS focus to matching Form 1099s with reported income rather than reclassifying workers.

IRS agents should be provided clear, non-discretionary rules under which to conduct their audits. The IRS should not operate under the apparent assumption that all independent contractor relationships are simply schemes to circumvent employment taxes. The IRS should concentrate on matching Forms 1099 with the actual income reported by independent contractors. The information is out there. General contractors have a significant incentive to file their Form 1099s, otherwise their subcontractor costs may not be treated as a legitimate business expense. As long as subcontractors are paying their fair share of taxes, the business relationship should be left alone. If the subcontractors are under reporting their income, go after them. Don't penalize the general contractor simply because he may have deeper pockets and can be easily located.

3. Institute consistency in enforcement.

Compliance should be enforced consistently. It seems that the IRS likes to set an example in a community by aggressively penalizing one company, the news of which spreads like wildfire, in hopes that other similar companies will be frightened into hiring their subcontractors as employees or just not using them in the future. All subcontractors should not be reclassified as employees simply to benefit the IRS in revenue collections or the Administration in providing employee benefits.

With respect to the newly introduced H.R.510, the Misclassification of Employees Act, I consider this bill a direct attack on the economic freedom of small business owners and individual entrpreneurs. It appears to assume that any business that utilizes subcontractors has misclassified them and is doing so simply to circumvent employment tax laws. The bill offers amnesty for taxes and penalties to employers who have wrongly "misclassified" their employees, who file correct tax information, and who promise never to use subcontractors again. Amnesty programs operate under the assumption of guilt. The use of independent contractors is neither an unintentional or willful wrong act that warrants the need for amnesty. I strongly urge this committee oppose such a proposal.

I appreciate the concern of this Committee and truly hope that action is taken soon to clarify the rules regarding the definition of independent contractors. It is extremely difficult for small business owners, such as myself, to continue to operate under such a cloud of uncertainty.

Again, I thank you Madam Chairman for inviting me to appear before you and your committee today to bear witness to the need for clarification of this issue. I am willing to answer any questions I can.

NARI is a not-for-profit trade association with nearly 6,000 member companies nationwide, representing over 40,000 remodeling industry professionals. NARI members are primarily residential home improvement contractors, and include national manufacturers and distributors of home improvement products and services.

Residential remodeling constitutes a $100 billion industry that has grown over 130 percent in the last ten years. With over 50 years of experience, NARI is committed to enhancing the professionalism of the remodeling industry and serving as an ally to homeowners. NARI is dedicated to the growth and betterment of the remodeling industry and related small businesses. For more information about NARI, contact Patti Burgio, director of government affairs, NARI, 4301 North Fairfax Drive, Suite 310, Arlington, VA 22203, 703/276-7600.

TESTIMONY OF DON OWEN, EXECUTIVE VICE PRESIDENT
P&P CONTRACTORS, INC., ROCKVILLE, MARYLAND

REPRESENTING

ASSOCIATED BUILDERS AND CONTRACTORS
1300 NORTH SEVENTEENTH STREET
ROSSLYN, VA 22209

BEFORE THE SMALL BUSINESS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES

THE DEFINITION OF INDEPENDENT CONTRACTORS WITHIN THE TAX CODE

JANUARY 19, 1995

Good morning Madam Chairman and honorable members of the Committee. My name is Don Owen and I am President of P&P Contractors, a drywall contracting business in Rockville, Maryland.

ABC is a national trade association representing approximately 17,500 contractors, subcontractors, material suppliers, and related firms from across the country and from all specialties in the construction industry. We represent 80% of the nation's construction workforce. Our diverse membership is bound by a shared commitment to the free enterprise system and the merit shop philosophy of awarding construction contracts to the lowest responsible bidder, through open and competitive bidding. It is an honor to be their voice before you today.

87-191 - 95 - 5

ABC appreciates the foresight of this Committee in addressing the issue of independent contractor status under the tax code. This has been a contentious issue in the past, and ABC welcomes the opportunity to work with the Committee to forge an understanding of the need in the small business community for independent contractors as well as the need for workable definitions.

In the small business world, independent contractors are often the perfect answer to a pressing need for special skills and know-how needed for short term projects. The flexibility an independent contractor provides to a small, fledgling operation creates numerous advantages for all parties involved. This arrangement allows the independent contractor to have the freedom to choose his or her work schedule, a small business owner the flexibility to adjust staff demands with business activity, and the consumer the opportunity to benefit from a reasonably priced, quality product. ABC believes that employers should continue to be able to make sound economic decisions about the classification of individuals as employees or independent contractors.

It is small businesses who benefit the most from the lawful utilization of independent contractors. They are a good source of labor for projects where the contractor does not need to exercise the type of control that would necessitate the hiring of an employee.

In the drywall business, independent contractors are used for very specific tasks such as framing and drywall hanging and finishing. They are small, insured contractors who move from

job to job and company to company. They own their own trucks and their own tools. These contractors greatly value their ability to work independently. The mark of an independent contractor is that he can control how, when, and where he provides services -- qualities greatly valued by many in the small business world.

In fact, many ABC members get their start running their own businesses by working as independent contractors. It is not unusual for these individuals to work as employees during regular hours and as independent contractors during off-hours and weekends. There is no better way to become established as a small business than to begin as an independent contractor. My company began this way in the early 1960s.

The construction industry as a whole faces a unique problem due to its high number of transient and seasonal workers. Because of the cyclical nature of the construction industry, many in the business could not afford to keep certain specialized trade craftsmen as employees. Sometimes skilled craftsmen are needed several times throughout the year, but not enough to warrant full-time or even part-time employment. You can see the burden to my firm if I had to place two or three extra framers on the payroll just to finish a two week project.

Under current law, taxpayers must use a 20 factor common law test to determine whether a worker is an employee or an independent contractor. The common law is judge made law -- yet lawyers and judges presented with simple three or five factor tests often have difficulty arriving at consistent results. Imagine the difficulty of a small contractor, not trained in the field

of law, but merely wishing to engage the services of a worker for some project, in confronting those 20 factors. Whatever changes are made in the tax laws that affect independent contractors must strengthen the 20 factor test by preserving its support of independent contractor status while simplifying its application.

The same common law, 20 factor test is used by the IRS to determine compliance. The IRS generally examines the classification of workers some time after the taxpayer has made its determination of the workers' classification and after the taxpayer has filed its returns. Thus, reclassification by the IRS can result in severe penalties in the form of back taxes and interest. ABC believes that Congress and not the IRS should define independent contractor status. By clearly setting out rules that encompass the 20 factor test, Congress can protect those in the construction industry and other industries who find it mutually beneficial to utilize independent contractors.

When considering the independent contractor issue, it is critical to distinguish between wrongful classification and misclassification. In construction, wrongful classification can result in a competitive edge. Those companies not paying employee taxes or workmans' compensation can undercut the competition by offering lower bids. ABC in no way condones intentional misclassification by businesses who shirk their duties to society and their workers.

On the other hand, simple misclassification or failure to file a 1099 form can easily occur through administrative error. A penalty should not apply in de minimis circumstances where the

taxpayer correctly issues information returns to most of its workers. Why should those who genuinely believe they are within the bounds of an admittedly vague law be treated in the same manner as those who purposefully violate that law to gain a benefit? Innocent businesses who have mistakenly misclassified a worker as an independent contractor can be subjected to back taxes that can literally bankrupt them.

The "safe harbor" provisions in Section 530 protect taxpayers from reclassification if there is a reasonable basis for treating workers other than as employees. This reasonable basis may come from published rulings, a prior audit, or industry practice. Section 530 recognizes that taxpayers must be able to rely on reasonable methods of classification without risking bankruptcy. The protection found in Section 530 are invaluable, especially to the construction industry with its long history of industry practice.

In addition to protecting past classifications, ABC believes that the time may be ripe to clear up the fog surrounding the 20 factor test for future classifications once and for all. A clean and simple test that recognizes the valuable role of independent contractors in the small business world would ease the way of the contractor struggling with a classification and make it easier to identify wrongfully classified workers. ABC would support such clarification as long as it preserves the current, mutually beneficial industry practice of properly utilizing independent contractors. ABC welcomes the opportunity to work with members of the Committee toward this goal.

For example, we should look at the grossly misunderstood questions concerning instructions, control and interpretation. Construction projects are like football games. There must be instructions, control, and interpretations in order to properly sequence the work. All subcontractors have to work in harmony, and therefore must work under a clear plan or schedule. A delicate balance must be struck to avoid misclassification of these individuals when they are simply carrying out their duty to build the project. Perhaps the emphasis should lie not so much on control by the hiring party but rather on the independence of the worker. The worker's own investment in training and tools, the worker's ability to perform services for several different people, and the contract under which the worker operates should all be considered.

Finally, I cannot understate the value to our nation of strong small business/independent contractor relationships. This is real grass roots empowerment which creates thousands of new small businesses every year. It is a big part of the equation for improving the lives of disadvantaged and minority Americans who are working hard for the opportunity to start their own businesses.

This concludes my prepared testimony. I would be pleased to address any questions from the Chair or other members of the Committee.

National Association for the Self-Employed

Testimony of

James Parmelee
Small Business Owner, Parmelee Associates

and

Member, The National Association for the Self-Employed

Before the

Small Business Committee
U.S. House of Representatives

on the

Clarification of Independent Contractor Status

January 19, 1995

Madam Chair Jan Meyers, Ranking Member John LaFalce, and House Small Business Committee Members, thank you for inviting me to testify today on the issue of independent contractors. I am James Parmelee, owner of Parmelee Associates, a business that provides media relations consulting and freelance writing to businesses and political campaigns on a contract basis.

I am not only testifying today based upon my personal experience as an independent contractor, but also as a member of the National Association for the Self-Employed. The NASE is a small business trade association representing over 320,000 small business persons from throughout the United States. Over 85 percent of the NASE members are business owners with 5 or fewer employees. Many of whom consider themselves to be independent contractors or who utilized independent contractors on a regular basis.

Small Businesses Support Clarification of Independent Contractor Status.

Small business owners, like myself, have long supported clarification of independent contractor status. Most of this support stems from the fear small business owners and the independent contractors they "hire" have from the subjective and unpredictable nature of the 20-factor test the IRS currently uses to determine whether or not an independent contractor relationship exists.

I understand that in 9 out of 10 audit cases, the IRS has reclassified the independent contractor as an employee. This scenario typically causes the business who hired the

independent contractor to face costly fines and penalties. This results in a negative "domino effect" on small businesses:

1) First, the businesses that utilize independent contractors to perform short-term projects or provide consulting expertise become leery of utilizing independent contractors.

2) This fear then has a direct impact on the independent contractors themselves who see businesses shying away from their services because of auditing fears.

It seems to me that both parties involved in an independent contracting agreement would benefit from clarification and simplification of the independent contractor status. Clearly, our economy would benefit from businesses operating more cost-effectively, and entrepreneurs creating jobs for themselves by setting out on their own.

Independent Contractor Policy Should Promote Entrepreneurism, Not Inhibit It.

In response to the intensity with which the IRS has pursued independent contractor audits, the NASE has previously called upon Congress to take steps to clarify the independent contractor status. The objective of that policy should be to accommodate changes in the U.S. and global economies toward more -- not less -- flexibility in employment and contracting arrangements. Today, more than ever, as large companies downsize, more and more people are reentering the job market by putting their name out on a shingle and going into business for themselves -- many as independent contractors.

While both the NASE and I support clarification of independent contractor status, we strongly oppose a carte-blanche grant of authority to the IRS to issue independent contractor regulations, which President Clinton proposed during last year's health care debate. Without clear and unambiguous safeguards built into the law, we believe that such a broad grant of authority is equivalent to "putting the fox in charge of the hen house."

Current IRS Guidelines are Subjective and Unpredictable, Provide Little Peace of Mind.

To make decisions on employee classifications, the IRS uses a list of 20 questions, derived from common law precedents dating back to the Magna Carta era, relating to the relationship between an employer and a contractor/employee. Not only is this 20 factor test antiquated, the NASE and others in the small business community agree with the Treasury Department when it calls this 20 factor test subjective.

In testimony before the House Government Operations Committee last year, Treasury Deputy Benefits Tax Counsel J. Mark Iwry stated that the 20 factor test has been "criticized as leading to imprecise and unpredictable results... "

Congress grappled with independent contractor status back in 1978 when it passed Section 530 -- broad legislation addressing the issue of who is an independent contractor and who is an employee. Congress once again tried to address this issue in the 1980s, but to no avail.

Section 530 clearly has flaws, it did attempt to provide employers with safe harbors for determining who is an independent contractor. The statute also imposes a moratorium on any IRS regulations involving independent contractor status.

This existing law provides most employers with relief from potential IRS reclassification of a firm's independent contractors as employees by prohibiting the IRS from reclassifying such workers if the employer has a reasonable basis for its treatment of the workers as independent contractors. A reasonable basis includes reliance on:

(1) judicial precedent or IRS rulings,

(2) a past IRS audit in which there was no assessment attributable to employment taxes, and

(3) a long-standing industry practice in treating the workers as independent contractors.

However, the "reasonable basis" protection was revoked for many technical service professionals such as engineers and computer programmers by Section 1706 of the Tax Reform Act of 1986.

In Conclusion.

The NASE does support the idea of a separate Congressional investigation regarding the tax treatment of independent contractors. But we believe that clear objectives must be set before such an investigation is undertaken. Any Congressional inquiry of this type should be based upon the need to foster and promote independent contractor status -- as opposed to heavily restricting its use.

In this regard, although we have not had a chance to review Representative Jay Kim's legislation in its entirety, we commend the Congressman for taking on the independent contractor issue for small business. We look forward to working with Congressman Kim and members of the Small Business Committee on this vital issue.

Once such an economic impact or review has been completed, the NASE would support a review of the 20 factor test now utilized in determining independent contractor status. Because of the subjective and unpredictable nature of the current test, small businesses have no security in knowing for sure if the IRS would agree that an independent contractor relationship exists.

The NASE believes that all taxpayers should pay their fair share of taxes. That is why we do support efforts to identify areas of potential abuse with respect to employment classification issues. The NASE supported this endeavor during the course of the health care debate when this authority would have been given to the Department of Treasury, and would continue to support such an investigation.

STATEMENT OF MARC S. WAGNER, CPA,
INDEPENDENT CONTRACTOR
REPRESENTING HD VEST FINANCIAL SERVICES

House Small Business Committee
January 19, 1995

Good afternoon. My name is Marc S. Wagner. I am here today in my capacity as an independent contractor for HD Vest Financial Services ("HD Vest").

Actually, I am here in a dual capacity. First, I am a small business entrepreneur. I own and operate my own accounting and financial planning business in Southampton, Pennsylvania, a northern suburb of Philadelphia. This is a classic small business, operated as a sole proprietorship with a staff of four. We provide a wide range of financial services to a diverse, but predominately middle class, client base. I have built a financial services firm capable of servicing all aspects of financial planning and investing, including a strong foundation in tax preparation.

More pertinent to the hearing today, I am also an independent contractor. I work as an independent contractor for a company called HD Vest, which provides financial advice and services to 1.5 million American families and businesses. Its activities include transactions involving insurance products, mutual funds, and unit investment trusts. These financial products are marketed and administered through 5,000 tax and accounting professionals like me across the United States. HD Vest is a member of the International Association for Financial Planning and the Securities Industry Association Independent Contractor Firms Committee.

HD Vest is an American small business success story. Founded by Herb Vest in 1983; it has grown from a very small business into a thriving enterprise. Headquartered in Irving, Texas, it now has more than 150 employees who help to service customers in nearly every corner of the United States. HD Vest was included in Inc. magazine's 500 fastest-growing companies in 1989 and 1990. Herb Vest has been profiled in Success and Forbes magazines.

HD Vest is unique among financial services companies because of the way it works with its representatives. I am a good illustration. Like most HD Vest representatives, I already own my own tax preparation or accounting business. I have an existing client base, and would be quite successful without this relationship with HD Vest. The commissions or fees I earn marketing Vest financial products and services are but a supplement to my existing operation. Vest provides little or no oversight of my operations. In fact, Vest competes with other financial services companies to provide services to me. In many ways, they work for me more than I work for them.

Vest representatives are truly independent contractors. We work on our own schedule out of our existing business, using our own equipment and staff. We set our own hours and cover our own expenses. We shoulder the entire risk of our enterprise, like any other small businessman, and market our financial services products to the general public, particularly to our existing customers. We are textbook examples of independent contractors.

There is one other important point about my relationship with HD Vest. I have specifically chosen to be an independent contractor, as opposed to an employee, for HD Vest. I have joined millions of others who have foregone the advantages of employee status such as employee benefits and lower taxes. I *like* being my own boss. I enjoy the freedom that independent contractor status allows me. I am first and foremost an entrepreneur and my association with HD Vest is only a part of the small business that is my livelihood.

I have three key points that I would like to make in my testimony today:

- The impact of any change to the independent contractor definition is potentially enormous. A significant change could dramatically increase

the cost of doing business for many small businesses, amounting to the functional equivalent of a substantial new tax.

- If changes are made, they must be made with care. The changes must be made *legislatively* by the Congress and not *administratively* by the Internal Revenue Service ("IRS"). The IRS's long-standing hostility to the use of independent contractors is well-known and well-chronicled.

- An example of the IRS' crusade in this area is an internal guidance paper now being drafted within the Service. The so-called coordinated issue paper ("CIP") targets the securities industry and provides auditing guidance to IRS field agents making worker classification decisions. The paper is flawed in a number of important respects.

General Background

Under current law, classification of workers[1], as either independent contractors or employees is based on the application of 20 common law factors to the worker's work environment. See Rev. Rul. 87-41, 1987-1 C.B. 296. These factors are all related to the extent to which an employer maintains control over his or her worker. In general, the more control an employer exercises over the worker, the more likely that worker is to be considered an employee rather than an independent contractor. According to existing regulations:

> [An employee relationship] exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the

[1] In this written testimony, the word "worker" will be used neutrally to describe a body of people that includes both employees and independent contractors.

> services are performed; it is sufficient if he has the right to do so ... if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor.
>
> Section 31.3121(d)-1(c)(2).

Over the years, this principle has been "fleshed out" by private letter rulings, revenue rulings, case law, internal IRS guidance documents called coordinated issue papers, the Internal Revenue Manual, articles, numerous IRS characterization decisions and a limited number of related regulations. There exists a substantial body of law and guidance in this area.

The independent contractor issue is not new, and neither is the charge that employers sometimes abuse the independent contractor designation. Indeed, some would contend there is an economic incentive to misclassify. The classification decision impacts the treatment of the worker under the Federal Unemployment Tax Act ("FUTA"), the Federal Insurance Contributions Act ("FICA"), and federal income tax withholding. In addition, under H.R. 3600, last year's proposed Health Security Act, there was even greater concern that employers would attempt to misclassify their workers to avoid the employer mandate – a requirement that employers pay at least 80% of the health insurance cost of their employees (but not independent contractors). As you all are aware, that legislation and specifically the idea of an additional burden on employers, in the form of a mandate, was specifically rejected by the last Congress.

After hearing the constant drum beat of criticism of independent contractors for three decades from the IRS, one might reach the conclusion that this is a disfavored designation. Nothing could be further from the truth. In previous testimony, the IRS has said that the law dictates no preference over "employees" or "independent contractors". They are simply two legitimate categories for the classification of workers. The independent contractor designation performs a legitimate function in a modern society where companies engage in a continuous stream of short term relationships for specified tasks. The alternative is a society where everyone hired by a company – from the temporary secretary, to the painter, to the data programmer, to the tax preparer – must be treated as an employee.

Key Points

1. The impact of any change in the definition of independent contractor is potentially enormous.

The impact of a change in the definition of independent contractors would be very significant on the small business community. The Small Business Administration ("SBA") estimates that almost one-third of all companies in the U.S. rely to some degree on independent contractors. The SBA estimates that there are 5 million independent contractors in America. According to some estimates, reclassifying an independent contractor as an employee increases an employer's cost by about 25%. Mr. Chairman, tightening the definition of independent contractor is the legislative equivalent of a substantial new tax on many honest, law-abiding companies. The ripple effect of this change will be felt by small business interests throughout the country.

Let me also point out the potentially sweeping impact of a definitional change. It could affect the social security and unemployment payments companies must make. It would affect the taxes they pay and the taxes withheld from their "newly classified" employees. It could affect the fringe benefits companies provide their workers, certain wage and hour laws, and workers' compensation. It has critically important implications on matters of malpractice and tort liability.

By way of example, the economic effect on HD Vest could be enormous. Last year, Vest conducted a study of the proposed changes to the independent contractor laws which were included in the Health Security Act. The study showed that had Vest's independent contractors been re-classified as employees in fiscal year 1993, its additional cost in taxes, workers' compensation and health insurance (which it provides to all employees) would be $12.3 million. $12.3 million represents a staggering 27% of its fiscal 1993 revenues of $46 million. In addition, $12.3 million is more than four times its net income of $2.934 million in fiscal 1993. I do not need to spell out to you the impact of a new tax of 27% on this company and other similarly situated companies in the financial services field.

Categorizing a change in the definition of independent contractor as a new tax is entirely appropriate, Madame Chairman. Imagine that you are a small company legitimately complying with the current independent contractor law. Imagine that as result of a change in law the definition of independent contractor is narrowed and no longer applies to your workers. For the purposes of this example, you now must make a social security tax payment of about $1,550, a medicare tax payment of $362, and a federal unemployment tax payment of $434 for each new employee. If you have a company policy of providing health insurance –as many in Congress have encouraged businesses to do -- you now must provide health care coverage at a cost estimated to be about $3,000 per person annually. As a small business owner myself, I can tell you that the long-term success or failure of a business is often determined by costs like these.

Together those additional costs – and there are others not included here – total almost $5,000 for a worker with an income of $25,000! Now in technical terms, this might not truly constitute a new 20% tax on that employee. But in the small business world, what you call it does not matter. What matters is that the cost of doing business for that single employee has just increased significantly.

What does this mean for an independent contractor like me? I do not have a crystal ball but I can make some educated guesses. First, companies like Vest are going to be less interested in associating with me because I will be much more expensive. In fact, after reviewing the estimate of additional costs prepared by Vest, one might predict that there will no longer be an HD Vest, and I will lose the opportunity to market this type of financial products and services. Even if Vest continues to operate and wishes to continue the much more expensive association with me, I may not be interested. As I mentioned earlier, I am an entrepreneur, a small businessman, and I have made a conscious decision not to be someone's employee.

2. <u>If changes are made to the definition of independent contractor, they must be made legislatively by Congress not administratively by the IRS.</u>

Section 7301 of the Clinton Administration's Health Security Act would have given the IRS what Chairman Archer called "carte blanche to treat workers as

employees." That provision, which granted the IRS authority to draft new independent contractor regulations, sent a chill through the small business community.

Over three decades, Treasury has made no secret of its hostility toward the independent contractor designation. In fact, remarkably, Congress has imposed a statutory prohibition against Treasury promulgating regulations affecting this area because of well-documented concerns about the IRS's overzealous pursuit of independent contractors in the past. That provision, Section 530 of the Revenue Act of 1986, was adopted after "taxpayer complaints" when the IRS increased its tax enforcement in the 1960's and 1970's and a "substantial" number of independent contractors were reclassified as employees (according to testimony by Evelyn A. Petschek of the Department of Treasury in 1992). Former IRS Commissioner Donald Alexander came before Congress in 1979 and confessed to "...too effective and hard-nosed" activities by the IRS regarding audits on the independent contractor issue. Others would use stronger terms to characterize the IRS's activities in this area. If the IRS is allowed to redefine independent contractors, then the ability of businesses and individuals to legitimately use the designation will be drastically limited.

I would like to bring to your attention an article in the December 15, 1993 Washington Post on this subject. It quotes D.J. Gribbin from the National Federation of Independent Businesses ("NFIB") saying, "From a business standpoint, the last people you want writing the rule is the IRS. We think it's pretty scary." There is also a comment from John Satagaj, the president of the Small Business Legislative Council, described as a "coalition of trade groups," who says, "[The IRS has] a very strong bias toward classifying individuals as employees."

There are legitimate reasons to review and perhaps revise the definition of independent contractor. The so-called 20 common law factors that serve as the basis for current classification decisions are nebulous and inconsistently applied. Drafting a new statutory definition will not be easy, but in this case, it is a job for the Congress, not the IRS.

3. The IRS's crusade against independent contractors is well illustrated by its current focus on the securities industry.

A current and alarming example of the IRS's crusade against independent contractors is the Service's ongoing plan to draft internal guidelines for field agents auditing in the securities industry. The IRS is currently drafting a coordinated issue paper or CIP which, once approved, will be disseminated to its field agents throughout the United States.

The first and most obvious question is whether this CIP violates the Section 530 regulatory moratorium. Some have argued that issuing an internal directive to its field agents is the functional equivalent of a regulation. Indeed, the CIP does exactly what a regulation does -- it establishes the policies and procedures the IRS will use when making worker classification decisions in the securities industry. If the CIP does not violate the letter of the law it certainly violates the spirit of the law. Certainly, from my perspective as an independent contractor, whether it is called a regulation, a CIP or anything else, the impact on me is the same. In fact, in one sense a CIP is worse than a regulation because there is no notice and comment and no formal opportunity for the industry to participate in its development.

There is another alarming aspect of the draft CIP. The draft CIP addresses the key issue in any worker classification decision -- how much *control* the employer exercises over his workers. The more control that is exercised, the more likely that the worker is an *employee* rather than an *independent contractor*. However, the draft guidance document goes a step further. It says, remarkably, that if an employer takes reasonable steps to ensure his workers comply with existing laws and regulations, that could constitute enough control to turn an independent contractor into an employee. Let me state that again from my perspective. To the extent that a conscientious small business owner like HD Vest takes steps to ensure that a representative like me complies with the law, HD Vest is increasing the chances that I will be declared an employee. This is particularly troubling in the securities industry where employers are required to ensure that their workers -- employees *or* independent contractors -- comply with a myriad of laws and regulations.

The IRS's position defies both common sense and common law. In North American Van Lines, Inc. v. National Labor Relations Board, the Court of Appeals of the District of Columbia stated the law: "[E]mployer efforts to ensure the worker's compliance with government regulations ... do not weigh in favor of employee status." 869 F.2d 596, 599 (D.C. Cir. 1989). We have consistently argued that this type of

supervision should be a neutral factor in worker classification decisions. Any other approach has the effect of discouraging companies from ensuring their worker comply with law, a result that makes little sense. So far, however, there are no indications that the IRS plans to alter its position on an employer's duty to supervise.

Because the draft CIP is currently targeted only at the securities industry, the duty to supervise issue would appear to apply only to that industry. Unfortunately, however, once this precedent is set in the securities industry, it could only be a matter of time before this interpretation is applied to other industries as well.

H.R. 3069/H.R. 510

In your invitation letter, you asked for my comments on H.R. 3069, a bill introduced in the last Congress and reintroduced in this Congress as H.R. 510, the Misclassification of Employees Act. While there are many interesting aspects of this legislation, let me comment on two points in particular.

First, I support Section 2(a), which "waive[s] employment tax liability for reasonable good faith misclassification based on the common law rules." Considering the current unclear state of the definition of independent contractors, it is critically important that we create an "out" for well-intentioned individuals who are determined to have misclassified their workers. Since the legislation neatly establishes a scheme to ensure the waiver only applies to "reasonable" errors, it is not susceptible to abuse.

Second, I have much less enthusiasm for Section 2(d), which eliminates the regulatory moratorium on the IRS. I am hopeful that some day the Congress will establish a new, thorough statutory definition of independent contractor that will allow the Section 530 moratorium to be removed. Until that time, however, for reasons outlined above, I strongly oppose any legislation that grants the IRS authority to draft new regulations in this important area.

Conclusion

Thank you again for your interest. The independent contractor issue goes directly and significantly to the bottom line of small businesses everywhere. It also affects my free choice to act as an independent contractor. I hope you will take steps to ensure the independent contractor issue is addressed in a manner that lessens rather than increases the cost and regulatory burdens on small businesses and independent contractors everywhere.

Thank you. I would be pleased to answer any questions you might have.

TESTIMONY OF THE

NATIONAL FEDERATION OF INDEPENDENT BUSINESS (NFIB)

Witness: Craig Willett, CPA

Owner, Willett & Associates
Provo, Utah

Subject: The Impact of Independent Contractor Reclassification on Small Business

Before: Committee on Small Business
U.S. House of Representatives

Date: January 19, 1995

The National Federation of Independent Business (NFIB) appreciates the opportunity to submit testimony on the issue of independent contractors and how they are being impacted by Internal Revenue Service (IRS) enforcement. NFIB is the nation's largest small business organization representing over 600,000 small business owners from all fifty states. The typical NFIB member has five employees and has $250,000 in gross annual sales. NFIB sets its public policy positions through regular polling of the membership.

What is an Independent Contractor?

Independent contractors are men and women who have decided to work for themselves instead of working for an employer. They are found in a wide variety of industries, and they usually control their own hours, work with their own equipment, and are not subject to the direct control of the business owner.

Independent contractors play a very important role in both our economy and our society. An independent contractor is a budding small business. Deciding to work for yourself is the first tentative step toward establishing business and that hires its own employees. The United States has a strong tradition in encouraging entrepreneurs and business creation. The decision to strike out on one's own as in independent contractor is often the first step in this process.

Independent contractors also serve a variety of functions that are not easily performed by employees. They allow a small business owner to temporarily hire someone with a skill that is needed by the business for a short period of time or on an occasional basis. It is not unusual for a business to have a variety of jobs arise during the year that cannot be handled with the current work force but that do not require hiring an additional employee. By hiring

an independent contractor, a business owner can have the job taken care of quickly without having to hire someone that may have to soon be let go. The availability of independent contractors allows small businesses to be more flexible and more competitive.

The Problems Created by Reclassification of Independent Contractors by the IRS

NFIB's concerns with current law are two-fold. First, NFIB is concerned that current law is so vague and confusing that it offers little guidance to small employers. It is virtually impossible for a small employer to determine whether or not any independent contractor working for him is misclassified by reading section 530 and the 20 common law rules.

NFIB has been repeatedly contacted by business owners who hired workers they were certain were independent contractors only to have the IRS later reclassify them as employees. This reclassification is not only unexpected, but it carries with it very large penalties.

Small businesses should not be subject to the retroactive reclassification of their workers. If a small business owner unwittingly misclassifies an employee as an independent contractor, that business owner should not be penalized because the IRS explanation is too vague to understand. If the IRS determines that the worker is an employee, the employer should only be required to treat that worker as an employee in the future.

NFIB's second concern with the uncertainty surrounding current law is that it may seriously hamper the ability of young entrepreneurs to quit their jobs and go into business for themselves as independent contractors. Many business owners are hesitant to hire independent contractors because they are concerned that these workers may later be reclassified by the IRS.

Simplifying current law will protect small business owners from mistakenly classifying an employee as an independent contractor, and at the same time, it will protect the independent contractors to the degree that employers will be more likely to use their services if the don't have to worry about future reclassification and IRS penalties when they hire them.

Solutions to the Problem

A variety of solutions to this problem have been proposed. They include: (1) creating an entirely new safe-harbor that would contain a simple definition of an independent contractor; (2) creating a numerical weight system for the 20 common law rules; and (3) completely changing the focus of IRS audits by putting less emphasis on classifying the employee as an independent contractor or employee and more emphasis on encouraging businesses to file their 1099 forms.

The only acceptable solution to the independent contractor problem must allow individuals the freedom to work for themselves and become independent contractors without putting an undue burden on employers.

A Simple, Expanded Safe Harbor

Section 530 of the Revenue Act of 1978 provides a safe harbor for employers hiring independent contractors. If the employer has:

(1) always treated the worker as an independent contractor;
(2) filed form 1099, reporting the worker's income to the IRS;
(3) treated workers in similar positions as independent contractors; and
(4) a "reasonable basis" for treating the worker as an independent contractor.

"Reasonable basis" means that the employer is relying on: (1) judicial precedent or IRS precedent; (2) a previous IRS audit which did not reclassify the worker as an employee; or (3) a long-standing, recognized practice of a significant segment of the industry.

For a small business owner who has always treated a certain type of employee as an independent contractor and has filed all appropriate forms but is unable to find clear legal precedent on whether or not his workers are independent contractors, this test means that there must also be a long-standing, recognized practice of a significant segment of the industry. How to prove that a practice is "long-standing" and performed by a "significant segment" of the industry is anyone's guess.

The section 530 safe harbor does not work for NFIB's members. Therefore, we proposed in 1991 and are currently reviewing adding a new, clearer safe harbor on top of current law. One way to improve current law would be to create a new, clearer safe harbor. If a business failed this new safe harbor, they would just fall under current law. This would prevent the inadvertent reclassification of a worker who is currently considered an independent contractor.

The NFIB proposal would classify a worker as an independent contractor if he met the following criteria:

(1) Maintains a principal place of business away from the employer's job site; or

(2) Has a substantial investment in assets used in connection with the performance of services; or

(3) Incurs substantial unreimbursed expenses in connection with performance of services; or

(4) Offers similar services in the normal course of business; or

(5) Risks significant income fluctuation with regard to the business as a whole; and

(6) Performs services pursuant to a written contract and the contract states:
(a) the worker will not be treated as an employee;
(b) the worker is responsible for the payment of taxes;

(c) the worker will provide the employer with a variety of information about the worker's business; and

(7) The employer reports all of the worker's income to the IRS.

This test would allow both independent contractors and those who employ them to quickly and easily determine whether or not the IRS will consider the worker to be an independent contractor.

Some have criticized this test as being too lenient because it could allow a wide variety of workers to become independent contractors. Yet, as long as a worker is paying his full share of taxes, it should not matter whether or not that worker is classified as an employee or an independent contractor. The law should not prevent a worker from becoming his own boss as long as that worker is willing to pay his full share of taxes.

The NFIB proposal would give workers the maximum amount of flexibility to choose the conditions under which they want to work. At the same time, this proposal protects the federal treasury by requiring employers to report all of the income their independent contractors earn. If employers do not report this income, the IRS will be able reclassify their independent contractors as employees, and the employers will be subject to severe penalties.

NFIB's proposal is modeled after one suggested by the GAO in 1977. The GAO recommended that Congress amend the law to allow separate business entities to be excluded from the common law definition of an employee. They suggested that independent contractors be considered businesses which:

(1) kept a separate set of books;
(2) take a risk of suffering a loss;
(3) have a separate principal place of business; and
(4) hold themselves out to be self-employed and/or make their services generally available to the public.

Weighing the 20 Common Law Tests

Under current law the IRS uses 20 common law tests that have been developed over the years to try to distinguish independent contractors from employees. These tests are:

(1) Is the worker provided with instructions as to when, where, and how work is to be performed?

(2) Was the worker trained in order to perform the job correctly?

(3) Are the worker's services a vital part of the company's operations?

(4) Is the worker prevented from delegating work to others?

(5) Is the worker prohibited from hiring, supervising, and paying assistants?

(6) Does the worker perform services on a regular and continuous basis?

(7) Who sets the hours to be worked?

(8) Does the worker work full time for the company?

(9) Does the worker work on the company's premises?

(10) Does the worker control the order and sequence of the work performed?

(11) Does the worker submit oral or written reports?

(12) Is the worker paid by hour, week or month?

(13) Are the worker's travel and business expenses paid by the company?

(14) Does the company furnish tools or equipment for the worker?

(15) Does the worker lack a significant investment in tools, equipment and facilities?

(16) Is the worker insulated from suffering a loss as a result of the activities performed for the company?

(17) Does the worker work just for one company?

(18) Does the worker make services available to the general public?

(19) Can the company discharge the worker at will?

(20) Can the worker end the relationship with the company without incurring any liability?

A worker need not pass all of these tests to be considered an independent contractor. In fact, the number of these tests a worker must pass varies. Since the IRS is enforcing these tests on a case-by-case basis, the results of the test are different from one region of the country to another.

Some have suggested giving a little more stability to these tests by assigning each a number of points. Although this may add a little more certainty to this process, it is unlikely to add enough that employers will be able to determine beforehand whether or not the person they are hiring is an independent contractor. This proposed solution would be of little or no value to the typical NFIB member because it would not clarify the problem enough for them to deal with it confidently.

STATEMENT OF THE
DIRECT SELLING ASSOCIATION
CONCERNING INDEPENDENT CONTRACTOR STATUS
BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

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Statement of the
Direct Selling Association
Concerning Independent Contractor Status
Before the
Committee on Small Business
U.S. House of Representatives

The Direct Selling Association (DSA) appreciates the opportunity to submit this statement in connection with the committee's hearings on independent contractors on January 19, 1995. DSA is the national trade association of the direct selling industry. We represent almost six million independent contractor direct salespeople and the 150 direct selling companies for whom they market goods and services. We have on average over 10,000 direct salespeople per Congressional district and, on the average, are presently recruiting over 50,000 distributors and salespersons per week. Our member firms account for over 95% of industry sales, and a majority of them are classified as small businesses.

The Independent Contractor Status of Direct Sellers
Is Well-Established for Federal Tax Purposes

The independent contractor status of direct sellers has long been recognized for federal tax purposes. Almost 20 years ago, direct sellers established themselves as independent contractors for tax purposes under the common law rules in the test case of Aparacor, Inc. v. United States, 556 F.2d 1004 (Ct. Cl. 1977). In 1982, Congress adopted I.R.C. § 3508 to "provide a statutory scheme for assuring the status of . . . direct sellers and real estate salespersons as independent contractors." (Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (1982), 382).

Internal Revenue Code section 3508 establishes three conditions in order for a person to qualify as a "direct seller" treated as an independent contractor by statute. First, the person must be engaged in the business of selling consumer products to any buyer on a buy-sell basis, deposit-commission, or similar basis, in the home or otherwise than a permanent retail establishment. Second, substantially all of the remuneration paid must be directly related to sales or output, rather than to the number of hours worked. Third, the direct selling must be performed pursuant to a written contract between the direct salesperson and the direct selling company, and the contract must provide that the direct salesperson will not be treated as an employee of the company for federal tax purposes.

As part of this statutory classification of direct sellers as independent contractors for tax purposes, Congress also adopted a special tax information reporting requirement for direct salespersons. See I.R.C. § 6041A(b). Under this special direct seller information reporting system, each direct selling company that sells $5,000 or more of consumer products to a direct salesperson must indicate so on a special direct seller box on the IRS Form 1099-MISC, which is then filed with the Internal Revenue Service and sent to the direct salesperson. This information filing requirement also applies to a distributor in a multi-level direct selling arrangement who is wholesaling to direct salespeople in his or her sales organization. In addition, the Form 1099-MISC is used to report the payment of commissions, bonuses, and awards to direct salespeople in excess of $600. The direct salesperson is required to provide his or her proper taxpayer identification number to the direct selling company as part of this process.

This statutory treatment of direct sellers as independent contractors and the special direct seller tax information reporting procedure constitute a clear and well-established system that has worked effectively for federal tax purposes for more than a decade and has achieved an extremely high rate of voluntary tax compliance for the direct selling industry. In discussions regarding independent contractor issues raised by last year's health care reform efforts, senior representatives of the Treasury Department and the Internal Revenue Service (IRS or "the Service") confirmed that the current statutory arrangement for direct sellers under Internal Revenue Code section 3508 is working well and has produced a good compliance record. Our latest compliance estimates run in the 97% range.

Independent Contractor Status Generally

DSA believes it important to the nation that legitimate use of independent contractors, by all industries, not be threatened. The IRS has exhibited in the past and reportedly continues today to have a severe antipathy towards independent contractors and self-employed individuals. This antipathy is, in all probability, based on the belief that tax compliance levels for these groups is too low relative to compliance by employee groups. From an enforcement point of view, Section 530 of the Revenue Act of 1978 was originally enacted by Congress (and then indefinitely extended in 1982) as a direct result of IRS harassment of independent contractors and misclassifications by the Service of independent contractors into employees. This harassment was done through abuse or misinterpretation of the twenty factor common law test of independent contractor status.

Finally, based on our own studies, people want to be independent contractors because they like being their own bosses, working their own hours, building their own businesses and directly relating effort to reward. Tax considerations generally do not enter the picture for them. While there are some tax benefits created by the use of independent contractors, there are also productivity, recruiting, retention and tax *disincentives* as well. Businesses and individuals should be free to choose within which structures they wish to operate.

Profile of the Typical Individual Direct Seller Small Business:

Direct selling is a well-established method for marketing products directly to consumers, primarily in their home, tracing its roots to colonial times. Companies within the industry market a broad range of consumer products and services, including household cleaning products, cosmetics and other personal care products, jewelry, cookware and other housewares, educational materials, household decorative products such as baskets, home improvement products, food, and vitamins.

Most direct selling companies within our industry are themselves small businesses. Over 99 percent of the individual direct salespeople that market these companies' products are independent contractors. Each of these independent contractors is, in effect a small business, most of them micro-enterprises.

Direct selling offers a broad opportunity for these individual entrepreneurs. There are virtually no barriers to entry into direct selling -- precisely because of their status as independent contractors. It is a field open to anyone. There are no demands that direct salespeople make significant investments, put in a given number of hours per day or week, or adhere to any sort of set work schedule. Direct selling is an ideal way for people with an entrepreneurial spirit to earn extra money without experience, without capital, and without having to make a full-time commitment to an employer. It is also a wonderful career opportunity where the sky is truly the limit.

As the result of this ease of access and flexibility in work arrangements, direct selling has wide appeal among women who have significant family responsibilities, as well as substantial numbers of minorities, the elderly, and handicapped persons. Of our almost 6 million independent contractor salespeople across the United States, 82 percent are women. Some 12.5 percent of direct salespeople are African-Americans, 4.7 percent are Hispanics, 1 percent are Asians, and .5 percent are Native Americans or Alaskan Natives. Approximately 4.5 percent are over age 65, and 8 percent have disabilities.

The overwhelming majority of direct salespeople conduct their direct selling activities on a part-time basis. Seventy-eight percent of direct salespeople spend less than 30 hours per week at direct selling, and many do it only for a few weeks or months per year. Some 57 percent engage in direct selling for less than 10 hours per week. Based on our latest data, only 6 percent sell for 40 hours per week or more.

In the great bulk of cases, direct selling serves as a supplement to family income, with the main household income source coming from outside the industry through the full-time employment of the direct seller, his or her spouse, or both. (Fifty-six percent of all direct sellers have traditional employment in addition to their self-employment as independent contractor direct salespeople. Eighty-six percent of direct sellers who are married have an employed spouse.) For 60 percent of salespeople, direct selling activities provide less than 10 percent of household income and for 72 percent of direct salespeople, direct selling produces less than 20 percent of family income.

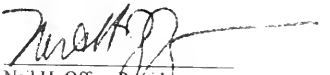
Conclusion

Industries seeking to protect the independent contractor status have traditionally received bipartisan support in Congress. Members of Congress have long understood the complexity of this "classification" issue and the need to protect this micro-entrepreneurial form of doing business. We are concerned, however, that any attempts to deal with the issues raised by this hearing might do inadvertent harm. Until now, Section 530 has proven to be the most inclusive, pro-independent contractor safe harbor test that Congress could enact. Any changes to this section of the law, whether they be designed to curb IRS abuses or to deal with the problem of misclassifications of employees in some industries resulting in competitive disadvantages for some firms, should be carefully handled. Inadvertent, unforeseen consequences harmful to industries legitimately using independent contractors must be carefully avoided. It is a very complex, economically significant area to both corporations and individual entrepreneurs. Experience has shown that there are many landmines in this area, and we urge that extreme caution be used in making any changes.

DSA appreciates the attention the Committee has devoted to this important and challenging issue. We trust that, as your deliberations continue, the legitimate use of independent contractors will be protected and preserved. We also respectfully urge that, in any changes in the law that might take place, nothing be done to endanger the statutory independent contractor status of direct sellers.

Thank you for your consideration of our views. We are at your service to expand on this statement, to answer any questions you might have or to provide additional information.

Respectfully submitted,



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Opening Statement

of

Honorable John J. LaFalce

Concerning

SBA Business Development Programs

I am pleased to participate in these hearings to review the business development programs of the Small Business Administration.

Most people have heard of the Small Business Administration, or SBA, but they generally think of it as being a lending source. Certainly financial assistance is a major component of the small business assistance delivered by the SBA.

Many years ago, however, we learned that simply providing financial assistance to a small business, or to a prospective small business, was not sufficient to facilitate that firm's participation in our economy. Simply stated, money alone won't buy happiness and it won't buy a successful small business.

Education is also necessary. Education on how to keep books and records, how to advertise and market, and even how to determine whether the business is operating at a profit or a loss.

Without this crucial information, providing financial assistance is actually performing a disservice to the borrower as that person will probably not only not make a profit, but will be unable to re-pay the loan from business income and may loose all of his or her personal resources.

Decades ago, we attempted to provide this education, or

management assistance and counseling, primarily through SBA employees. This did not work.

We have now turned to outside sources such as SCORE, Small Business Institutes, Small Business Development Centers and other specialized entities.

As a result of the efforts of these entities, we are learning that with the proper assistance, most small businesses can succeed, not fail.

I believe that continuation of these efforts to educate small business are critical to the survival of the small business community.

I congratulate Chairman Meyers on convening this hearing today and I urge my colleagues on the Committee and in the Congress to pay close attention to the testimony we will receive today.

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